S. HRG. 101-801

IMPLEMENTATION OF THE BRADY PLAN

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL DEBT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

MARCH 2, 1990

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

32-670 ⇆ WASHINGTON : 1990

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

S361-42

COMMITTEE ON FINANCE

LLOYD BENTSEN, Texas, *Chairman*

SPARK M. MATSUNAGA, Hawaii	BOB PACKWOOD, Oregon
DANIEL PATRICK MOYNIHAN, New York	BOB DOLE, Kansas
MAX BAUCUS, Montana	WILLIAM V. ROTH, JR., Delaware
DAVID L. BOREN, Oklahoma	JOHN C. DANFORTH, Missouri
BILL BRADLEY, New Jersey	JOHN H. CHAFEE, Rhode Island
GEORGE J. MITCHELL, Maine	JOHN HEINZ, Pennsylvania
DAVID PRYOR, Arkansas	DAVE DURENBERGER, Minnesota
DONALD W. RIEGLE, JR., Michigan	WILLIAM L. ARMSTRONG, Colorado
JOHN D. ROCKEFELLER IV, West Virginia	STEVE SYMMS, Idaho
TOM DASCHLE, South Dakota	

VANDA B. MCMURTRY, *Staff Director and Chief Counsel*
EDMUND J. MIHALSKI, *Minority Chief of Staff*

SUBCOMMITTEE ON INTERNATIONAL DEBT

BILL BRADLEY, New Jersey, *Chairman*

DONALD W. RIEGLE, JR., Michigan	BOB DOLE, Kansas
	WILLIAM L. ARMSTRONG, Colorado

CONTENTS

OPENING STATEMENT

Page

Bradley, Hon. Bill, a U.S. Senator from New Jersey 1

COMMITTEE PRESS RELEASE

Finance Subcommittee to Hold Hearings on International Debt; Implementation of Brady Plan to be Reviewed, Bradley Says 1

PUBLIC WITNESSES

Tucker, Stuart K., fellow, Overseas Development Council, Washington, DC 4
Sachs, Jeffrey D., Ph.D., Galen L. Stone professor of international trade, department of economics, Harvard University, Cambridge, MA 7
Bergsten, C. Fred, director, Institute for International Economics, Washington, DC 12

ALPHABETICAL LISTING AND APPENDIX MATERIAL SUBMITTED

Bergsten, C. Fred:
Testimony 12
Prepared statement 35
Bradley, Hon. Bill:
Opening statement 1
Prepared statement 39
Sachs, Jeffrey D.:
Testimony 7
Tucker, Stuart K.:
Testimony 4
Prepared statement 40

COMMUNICATIONS

Islam, Shafiqul 44

IMPLEMENTATION OF THE BRADY PLAN

FRIDAY, MARCH 2, 1990

U.S. SENATE,
SUBCOMMITTEE ON INTERNATIONAL DEBT,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:10 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Bill Bradley (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

[Press Release No. H-15, Feb. 28, 1990]

FINANCE SUBCOMMITTEE TO HOLD HEARINGS ON INTERNATIONAL DEBT; IMPLEMENTATION OF BRADY PLAN TO BE REVIEWED, BRADLEY SAYS

WASHINGTON, DC.—Senator Bill Bradley (D., New Jersey), Chairman of the Senate Finance Subcommittee on International Debt, announced Wednesday that the Subcommittee will hold a hearing to review the implementation of the Brady Plan, and to explore possible ways to improve and broaden it.

The hearing is scheduled for *Friday March 2, 1990 at 10 a.m.* in Room SD-215 of the Dirksen Senate Office Building.

The Brady Plan, devised by Treasury Secretary Nicholas Brady, is the Bush Administration's attempt to address the Third World debt problem. The plan is designed to ease the burden of foreign debt owed by developing nations. The Treasury Department mediates negotiations between commercial banks and debtors for rescheduling and reducing Third World debt.

"A year has passed since the Administration accepted the concept of debt relief. It is now time to review the extent to which the Brady Plan has succeeded in alleviating the debt problem, and perhaps to suggest some modifications. Recognizing the relationship between debt, development, democracy, and drugs, it is vital that we continue to work to find an effective solution to the debt crisis," Bradley said.

OPENING STATEMENT OF HON. BILL BRADLEY, A U.S. SENATOR FROM NEW JERSEY

Senator BRADLEY. The subcommittee will come to order.

The purpose of the hearing today is to explore the relationship between debt, development, democracy, and drugs; to review the implementation of the Brady Plan for debt relief in its first year, and to suggest possible modifications of the current debt relief approach; and to study the applicability of the debt-relief concept for Eastern Europe.

Almost exactly a year ago, the administration recognized that debt reduction can alleviate the debt burden that has been driving many developing countries into deep poverty. I welcome this decision. Secretary Brady's speech marked a major turn away from his predecessor's belief that the answer to too much debt was more debt. But I felt it appropriate to wait to see how the new Brady

Plan would be implemented before offering more detailed opinions of the plan.

A considerable amount of effort has gone into implementing the plan over the past year. In May, the international financial institutions and Japan agreed to provide $30 to $35 billion to support debt-relief operations on a case-by-case basis.

The first beneficiary of the plan, Mexico, signed its debt-relief agreement on February 4 of this year. Costa Rica has nearly wrapped up a program to buy back virtually all of its commercial bank debt at about 16 cents on the dollar. The Philippines is working on a program for new money, and Venezuela is undertaking significant reforms with an eye to entering negotiations with the banks very soon.

But even if the Mexican deal is considered adequate, and some doubt it is, there is considerable question as to whether the plan as currently constructed can readily be applied, beyond those countries that I have already mentioned, to the 15 other severely indebted middle-income countries.

The banks, most of which have established significant reserves against their LDC debt, seem extremely reluctant to enter into new negotiations. Major debtors, especially Brazil and Argentina, are using arrears to obtain debt relief and are questioning whether the Brady Plan can offer them anything better. The international financial institutions and the creditor governments appear to recognize that we have hit an impasse but have yet to suggest useful ideas to break the log jam.

So, that is basically where we are. I am deeply concerned that what I call "debt fatigue" has now overcome the negotiators, and that we are now in a prolonged period of muddling through. If so, this course can only lead to serious problems.

The severely indebted middle-income countries simply cannot sustain net resource transfers to the developed world of the magnitude they suffered last year, which is some $50 billion. They cannot afford to see further major declines in real incomes; they can't afford the hyperinflation that servicing their foreign debt might lead to, they cannot afford to have scarce government resources taken away from education and health; and they can't afford to sustain increases in infant mortality rates.

Well, I don't think we can afford it, either. This impoverishment offends our humanity, could endanger our national security, and directly affects our economic interests through reduced U.S. exports.

It is therefore essential that we ensure that the burden on these countries be reduced, responsibly, to a point where countries can return to growth.

I want to emphasize that I believe strongly that the greatest single impetus to growth in the developing world will come through access to the import markets of developing countries, not only the United States but also Japan and Western Europe.

There is perhaps no more important instrument for growth than a liberal trade regime, enforced through the General Agreement on Tariffs and Trade. The success of the current Uruguay Round of GATT negotiations is essential. The developing countries have a

deep stake in this and they must also be willing to assume the responsibility of maintaining and enhancing the GATT regime.

But trade, is insufficient. Some relief from the net outflow of resources from these countries is essential. The World Bank believes that the burden of servicing the debt overhang in developing countries has fallen most heavily on investment, thereby reducing the long-term growth potential of these countries. The potential growth lost from the $70 billion that have flown from the Baker-17 to the creditors cannot be restored, but future drains of such magnitude can and should be prevented.

Currently, the Brady Plan is the only instrument to provide this relief. The question is, is the plan in its current form sufficient to this purpose? Does it ensure that the necessary resources remain in the country? If not, what are the implications for development, for drugs, for democracy? Can or should the plan be modified? Is it enough to address the burden of commercial bank debt? Or should creditor-governments consider forgiving official debt, as they have recently decided to do for the low-income countries of Sub-Sahara Africa?

The question of official debt reduction is particularly germane to the Eastern European countries included in the World Bank's list of severely indebted middle-income countries, in particular Poland and Hungary.

Poland labors under one of the highest debt-service burdens in the world, and 70 percent of its debt is from official sources. Hungary, on the other hand, whose per capita debt burden exceeds that of Poland, owes most of its money to commercial banks.

In both cases, as elsewhere in Eastern Europe, the people have brought about a most courageous change, throwing off the bankrupt system that has been imposed on them for 40–50 years. The West needs to be able to support them, to ensure that their experiment with democracy and market economies succeeds. Aid alone may not be enough. We should consider, also, the extent to which debt reduction can fuel these countries' growth.

It is with that opening thought in mind that I am very pleased that we have such a distinguished panel here today, of Messrs. Tucker, Sachs, and Bergsten.

Let me welcome the three of you to the subcommittee. I think the accumulated wisdom on the panel equals or exceeds any to have appeared in the Finance Committee in a long time, and I appreciate your willingness to appear as a panel, together, and to share your views.

What I suggest is that Mr. Tucker open the discussion, by focusing on the impact of the debt crisis on LDC development. Then, Mr. Sachs and Mr. Bergsten, to discuss more in detail the implementation and possible modifications of the Brady Plan; and if you would, as well, deal with its applicability to Eastern Europe.

So, Mr. Tucker, thank you very much.

[The prepared statement of Senator Bradley appears in the appendix.]

STATEMENT OF STUART K. TUCKER, FELLOW, OVERSEAS DEVELOPMENT COUNCIL, WASHINGTON, DC

Mr. TUCKER. Thank you, Mr. Chairman, for inviting me to appear before this panel.

I want to make it clear that my remarks are my own and are not to be attributed to the views of my colleagues or board members at the Overseas Development Council.

The thrust of my written remarks are that the United States has two substantive reasons for doing something about the debt crisis: (1) we have a self-interest (in markets, job creation, investment opportunities); and (2) there is a humanitarian crisis out there in the debtor countries that we ought to address.

I will basically skip the part about the United States, as we have heard this many times before. There have been hundreds of thousands of U.S. jobs lost because of the debt crisis due to our lost exports.

But more important, I think, from the point of view of what this panel is trying to address, is what it means for long-term development—in effect, what are the 1990's going to be like because of the debt crisis? I list a number of points in the written testimony, which I will briefly summarize.

First of all, we have seen in the 1980's a curtailment of the income growth path of debtor countries. Whereas, in the sixties and seventies these countries grew, on a per capita income basis, 4 percent a year, they are roughly growing 1.5 to 2 percent now. Projections in the 1990's do not expect them to get back up to 4 percent. And that, of course, is after the decline in the early eighties, which was some 10 percent of their income.

The ultimate impact is that these countries have lost at least a decade of time in their development process; and, in fact, for them to catch up with the growth path that would be extended from the sixties and seventies forward, through time, would require them to grow at 4.5 percent for a generation. Clearly, the impact of the debt crisis has been a substantial loss of income--essentially wealth that could have been reinvested in the development process. This has been a tragedy that we all must recognize.

Over the course of the period 1980 to 1988, slow growth caused roughly $2 trillion of income to not be generated in 17 highly indebted countries. This was almost four times as much money as they paid to creditor banks.

A second effect of the debt crisis has been a contraction of consumption. Actually, many of the countries tried not to contract their consumption during the early phases of the debt crisis; they in fact sacrificed long-term investment in order to maintain consumption levels. But the bottom line is that the income lost has forced them to reduce consumption levels on a broad level of society, and the lack of investment over recent years means that in the future their consumption levels will be curtailed compared to a reasonable non-debt-crisis hypothetical future.

A third effect has been that public sector capacity has been reduced dramatically. Interest payments in government spending have risen in Latin America from 9 percent to 27 percent of their budget. That means 18 percent of their government spending has

had to be shifted out of things like education, health, welfare, and economic services. This has meant the public sector has not been there to support the working classes during the economic recession.

Another effect has been that the impact on these social programs—education and health, primarily—has been a shifting away from spending on the longer term investment—no clinics, no books, no schools—to the point that in the 1990's there is a deficit of investment in social infrastructure. In effect, we have a burgeoning social-debt crisis developing in Latin America, because of the 1980's record of spending only to maintain current operations and not investing in future needs to manage what is a rapidly growing population in debtor countries.

Of course, the debt crisis has its well-known effect on trade. Latin American countries, in particular, have had to shift from trade deficits to trade surpluses in order to have the foreign exchange necessary to repay the debt.

This has become a structural phenomenon; as long as they continue to have net resource transfers on the financial side back to the creditor nations, they will have to maintain trade surpluses. In many ways, this has forced them to focus upon export incentives that deprive some of their domestic consumption.

More importantly, I think, we have begun to see in the agricultural sector an emphasis on productivity at the expense of a number of other areas, which brings me to the issue of the environment.

We have seen in many Latin American countries a sacrifice of the environment—through the use of pesticides and other products. Deforestation has run rampant throughout those areas with large amounts of wooded areas, in order to support an export drive of primarily agriculture or semiprocessed products to industrial countries.

This has been a natural process that was happening before the debt crisis, admittedly; but it has accelerated as a result of the export imperative.

Another effect is that the lack of agricultural opportunities, due to the compressed commodity prices in the 1980's, has led to a significant urbanization trend. Again, that was taking place before the debt crisis, as well. However, it has accelerated, as the agricultural or rural opportunities have dried up, and we now see urban slums. As we have mentioned before, public spending has dried up. We don't see the services necessary to keep the urban poor living on a normal level. This has led to even worse environmental conditions within the cities of the Third World.

After 8 years of severe debt crisis, Latin America has thrown out most of its military leaders. One could say that the debt crisis has had a positive political impact. Unfortunately, the tools that are in the hands of the democratic leaders today are no better than the tools that the military governments had; and, in fact, the conditions are much worse.

I suspect that many of these democratic leaders are finding it difficult to meet the demands of their populations. We have now begun to see very populist leaders come forward with anti-repayment platforms. These people are not only populist in the political sense, they are popular in the electoral sense. And that means that

we are going to be in for a period of political instability in the next few years, because they, too, will not be able to meet the economic needs of their society.

On top of all of this, we have continuing population pressures. In particular, the African debtors have even higher rates of population growth now than they did in the 1970's. This is a dramatic change, and something that runs counter to all our aid efforts to try to help them with population planning, to overcome the burdens of extra people. But, let's face it. When you are facing low income, if you are a rural farmer, you are going to want to have more children to help you with, basically, tasks that you would normally have hired laborers to work the farm with.

So, it is a natural sociological response, in effect, to increase population growth in the face of economic stagnation, and we have not been able to overcome that with our aid policies. Certainly in the 1980's, population planning was de-emphasized in U.S. policy, which further aggravated the problem.

I don't have alot to say about narcotics, but I do think we have to recognize that the U.S. policy right now is, in effect, creating more and more reason for a local producer in Latin America to enter narcotics production. By constraining production and by constraining trade, in the face of what is still a rapidly growing demand in the United States for drugs, we see that the cost differential between producing something legal and the high price they are going to get for producing something illegal is of such magnitude now that many producers are going to take the risk, and they are going to go into production of drugs.

I think, in effect, we are in a self-defeating game if we continue to try to suppress drug production without supplying alternatives to the population. They need income from other mode before they are going to find it viable to stop illegal activities. I shall not comment on the middle-men, which I think is a different issue.

Finally, there has been some long-term progress sustained through the 1980's on physical standards of living. We continue to see progress in infant mortality, child mortality, literacy, and life expectancy in most debtor countries. However, the rate of progress has slowed considerably.

We can't yet establish a direct causal linkage between spending on these issues and the rate of progress, but we do see the phenomenon in the statistics. We conclude, rather implicitly, that there must be some connection between the debt crisis and this slowing of social progress.

Furthermore, the lack of investment in social spending issues over the 1980's means that that progress will probably continue to slow in the 1990's, as the Latin American societies are incapable of making up for the lost ground on the investment side.

So, in conclusion, absolute poverty is the major problem to be addressed in the 1990's, and my paper supplies some evidence that it has effects on the U.S. economy, as well. We have a number of environmental and social ills that are being fostered by it, and we must overcome them if we can.

But let us realize that, even if the financial side of the debt crisis were resolved tomorrow, by the Brady Plan or some modification of it, the world would still have to live with the effects of the debt

crisis for some time to come. This is the human tragedy within which all development policies in the 1990's must operate.

Senator BRADLEY. Thank you very much, Mr. Tucker.

[The prepared statement of Mr. Tucker appears in the appendix.]

Senator BRADLEY. Dr. Sachs?

STATEMENT OF PROFESSOR JEFFREY D. SACHS, PH.D., GALEN L. STONE PROFESSOR OF INTERNATIONAL TRADE, DEPARTMENT OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MA

Dr. SACHS. Thank you, Senator.

Let me commend you on overcoming debt fatigue to have these important hearings, because you have been at it longer than any other member of the U.S. Senate. You have continued to battle for the right purpose and have made enormous progress in doing that, and I think the whole world owes you a debt of gratitude, if I could say so, as a debt of gratitude to you.

Senator BRADLEY. You can certainly say so. [Laughter.]

Dr. SACHS. We are at the first anniversary of the Brady Plan, and I think we can say there is undoubted progress being made. Again, it is progress in the direction that you pointed to. But I think we have to acknowledge that the crisis, in substance, remains very grave despite the turn of official policy in this area.

We have just heard from Dr. Tucker about the continuing extent of economic crisis. I would point out that there are now more hyperinflations in the world underway, all of them in debt-ravaged countries, than ever before at one time in all of human history up until this point. That, for me, is an indication of just how profound the economic and financial crisis is.

You have two hyperinflations in Eastern Europe, and in South America you have three hyperinflations right now. And to get to a hyperinflation, since there have only been 15 in all of world history that we know, and to have five going on right now, is a measure of just how grave the financial imbalances are in the world. All of these hyperinflations throughout history have involved—or almost all of them, and certainly the ones now—have involved the grave burden of the foreign debt upon the finances.

Another indication of the depth of the crisis is that the secondary market prices of the debt, our weekly indicator, continue to decline, showing that the markets not only are not believing the countries are becoming more credit-worthy, but less.

The distance of these countries from market access, which was a goal long ago established, recedes farther and farther from the mind. Now it is almost universally acknowledged that these countries will not come back to the market. And the banks, except for one or two banks in the world, are quite explicit about the fact that they have no interest in these countries in the longer term, and most banks are exiting.

Third, and somewhat more positively, in its way, the banks, because of the growing and—now, I would say—conclusive doubt about the viability of debt payment, have reserved up to levels of 70–80 and sometimes 100 percent of their exposure. There is not a major bank in the world that is threatened by the debt crisis anymore, and even our chairman of the FDIC said, more than a year

ago, to the Congress, that if all six of the major debtor countries completely wiped out their debts, it wouldn't mean a penny of damage to the FDIC. I think that was a rather striking statement made to the Banking Committee in January of last year, that this is simply no longer a banking crisis.

Now, I think it is clear that the shift that the Treasury made March 10 last year, with the announcement of the Brady Plan, has been highly desirable, in concept. It was recognized early on by you, Senator, and by others that this debt was not payable and that we had to move down the road of debt reduction.

But if we look at how the plan is proceeding right now, I think we have to have rather considerable concern—indeed, I would say grave concern, for many countries.

First I would indicate that the 17 countries you cited, 15 or 17 heavily indebted countries, is not the appropriate full list to work with. There are 39 countries—most of them very small in a quantitative sense but very important for themselves, and in many cases important for our foreign policy interests as well—that are on the list of countries actively renegotiating with their commercial banks. And the list of countries whose debts sell at a very deep discount in the secondary market goes well beyond the list of 17 countries.

The universe I would put at around 40 for the commercial banks. That was the list that the World Bank used last year. And if we add a number of gravely damaged and weakened, very poor countries that are in the category of an official debt crisis, one would add some Sub-Sahara African countries at least to that list of 40. So, there are a very large number of countries that we should be examining with respect to the process of debt reduction.

What we have seen in the debt-reduction process is a very haphazard set of steps this year, and mainly the progress has come where the Treasury has turned its active attention.

We know, now, as we could have known logically a year ago, that voluntarism in debt reduction is a non-starter; it can't work. And we know now that the only time we get agreements under the current set of rules is when the Treasury does considerable arm-twisting to try to bring an agreement to fruition. This is not an appropriate way to proceed, but it is the nature of the rules of the game right now.

There are hardly any rules except the ones that the Treasury picks out. Mexico was top on the agenda, and appropriately so for our interests, and the Treasury invested a considerable amount of time and came up with what I would classify as a "fair," though not "good," agreement. I would put it in the category of "mediocre"—not good enough for our national interests, not good enough for Mexico's. There is a chance of it working, but there is a very good chance that we will have to revisit the issue. Despite the fact that the Mexican Government has said the debt crisis is behind them, there is plenty of evidence that it doesn't reach far enough.

The second agreement that has been reached is with Costa Rica. I would classify that as a very fine agreement. That came about because Costa Rica kept at it for 3 years, fought hard, negotiated well, and the U.S. Government supported the Costa Ricans at the end in putting this package together. But if one looks at the details

of that, that is truly significant, an across-the-board debt reduction of the kind that they need, and I think it meets their needs.

The third agreement in this tally is the Philippines, and I would hardly count this as a Brady Plan agreement. There is a very marginal reduction of their debt. They were told by the United States and others, "Do it the voluntary way," and the voluntary way is that they took a nibble, they got a little bit of new lending, certainly much less than they thought and much less debt reduction than they need. So it is not really what one would call even "mediocre;" it is very poor.

I would say there are 35 other countries, many of which will need to go through this process, and, at this pace, the process simply doesn't work.

One of the things I will stress is that we need to move, beyond a strategy where it depends on the active involvement of the Treasury Secretary to do this, to a rule-based procedure under the auspices of the International Monetary Fund.

And it should not be just our Treasury Secretary leading this effort. It is likely to result in insufficient debt reduction and nonsystemic treatment of the problem.

Now, I would ask, operationally, is the program doing what it is supposed to be doing, in the sense of helping reformist governments carry out reforms and get stabilized? I think the answer is, because of the very, very slow progress and because of the extremely ad hoc procedures or—you can't even call them "procedures"—the ad hoc nature of this process, it is not having that role in the vast majority of countries.

Usually, when a government gets elected these days, the first thing that happens is that John Reed appears the next day in the country to announce that that country is not eligible for a Brady Plan debt reduction, and it stirs the political environment enormously. It roils the environment, rather than calming it. It sets back the process of reform. It creates an enormous umbrella of uncertainty, which cripples the ability to move forward, and nobody on the official side says much at all—the IMF or anybody else.

Venezuela, which you mentioned, Senator Bradley, started out an extraordinarily ambitious reform program with very tough austerity measures, which we know prompted an enormous human tragedy last February, when 300 people died in rioting as the result of price increases under the austerity program.

Contrary to what some might have thought, Carlos Andros-Peras not only did not back off his program, he reinforced it, stuck with it at that point; but the official community has given absolutely no help to Venezuela.

It is not that they are starting negotiations with the banks. For 1 year, they have heard from a few of our leading bankers, "No way! No interest! No chance!" And the fact that there is no official process for a country like that is deeply, deeply destabilizing, politically, because what Peras told the public was, "We will get help in the form of debt reduction, but we must suffer through this process."

Now he is under enormous political attack at home, in a very difficult situation, because there has not been adequate progress on the debt. He is being squeezed to accept an inadequate debt agree-

ment, which may allow the big banks to totally avoid a contribution, and having, again, some fringe debt reduction, because he had promised that the counterpart of his measures would be progress on getting Venezuela out of its crisis. So, by that measure, you can see that the program doesn't work.

No one has stood up in our Government, in the World Bank, or in the IMF to say, "Look at what this man is doing. We strongly support the necessary amount of reduction for the debt," which the IMF, on its balance-of-payment numbers, shows should be on the order of 50 percent reduction, that, "We support this process, and we will give comfort to Venezuela during the negotiating process." Quite the contrary. They are off on their own, fighting the banks, with some recalcitrant heavy-hitters among the banks, and the process has been stalemated for a year. The political cost of that is enormous.

One sees it similarly in Ecuador, where no progress is made. One saw it in Argentina, where Menim got off to a good start, but the official community did not say, in an orderly, organized way, "Here is a path for you that is consistent with your needs. Now, carry on the reforms, and we will work on getting the kind of reduction that is necessary." Instead, you had this incredibly convoluted public debate, with Citibank saying, "Well, we would like some debt-equity swaps, and we would like to invest in this and that," and other banks saying, "No way for Argentina," and the IMF and the World Bank, essentially quiet on this, and no orderly procedure for that government to be able to say, "We must proceed on the internal reforms, but there is an orderly path for us to get what we need for reduction of the debt so that our reforms can be successful."

All a government can do these days is to tell their people, "My God, we hope we get the attention of the Treasury at some point." And internally in these countries, since it is not clear, you have many opponents who say, "We will never get the relief," and who are backed up by U.S. commercial bankers who fly in and say, "No, you are right, you will never get the relief."

It becomes an enormously convoluted process, which simply doesn't meet exactly what it was supposed to meet, which is hope and political comfort for reformers during the difficult period of the shock of the reforms, with a process put in place that systematically gets to the financial needs at the end of the line.

So, Brazil? I hope we can do better, because what more important debtor is there, from a quantitative sense, than Brazil? A new government has just been in place, and I presume we are going to hear the same complicated debate taking place.

Now, what is needed—and then I will hurry to the end—what is needed to make this thing work?

For the reform process, we must first have the concept that in any sharp reform process you need a financial standstill at the beginning. Countries cannot be expected to service a heavy portion of their debts and end hyperinflation at the same time. It is like what Chapter 11 does: it triggers a standstill on the debt payments, to give the breathing space to carry out the reforms. We don't have that process in place.

Second, we need a well-defined procedure inside the International Monetary Fund, where the extent of debt reduction is linked to the technical analysis of debt-service capacity over a medium term. And we don't have that, either.

On the one side, the IMF does that kind of analysis. It shows these countries cannot hope to regain credit worthiness in 5 years under the normal rules of the game. And then, on the other hand, that technical analysis is put to one side, and the countries are thrown into the negotiating room with the commercial banks and asked to fight for their lives, in a procedure which is totally divorced from the substantive analysis about the debt situation.

Third, we need a procedure to avoid free riding and for comprehensive reduction. This process has been twisted out of shape, out of recognition, to a normal financial workout, by Citibank, mainly. That is because you have one bank that doesn't want to give that reduction and thinks that new money is somehow equivalent.

That led to avoiding the normal way of proceeding, which is an across-the-board agreement for all creditors in a particular creditor class, which is the most fundamental rule of a bankruptcy or financial workout, that creditors share across the board in whatever is done. Either the interest is reduced, or the principal is reduced, or some combination.

Instead, you have a complex menu of options which doesn't really suit anybody's needs; it just allows for the free riding, it allows for dragging on negotiations, it allows for some banks to say, entirely, "We want out of the process," and it stops the clean, appropriate, simple way that bankruptcy operates, in the sense of saying, "We need across-the-board measures."

Again, the IMF is the appropriate place to insist on the extent of debt reduction that is needed.

I wanted to say one short thing about the content of the Brady policy reforms that are supposed to go along with this, and in discussion, perhaps we can talk about adding more social awareness to these policy reforms.

Let me turn to the last question that you mentioned, and that is about official debt, because it applies to Eastern Europe, and it applies to the Andean countries in South America.

There are some countries for which the commercial bank debt is not the main problem, but rather the Paris Club bilateral debt. We must address this more systematically than we have, because the overhang of official debt for some countries is deeply damaging to U.S. interests.

The two categories that come to mind most immediately are in the Andean coca-producing countries, Peru and Bolivia, where no one is collecting on these debts; where no one can hope to collect or expect to collect, but where the official debt overhang remains a crippling burden to reform and indeed to virtually normal survival for a lot of people; and where we could entertain a program of converting the proceeds of payments on this debt into an anti-narcotics effort.

Senator Biden has started to explore this kind of option. I think it is a highly desirable option and one that we should think very, very seriously about. The details and mechanics are complex and have not been worked out yet, but I think it is the right direction.

Finally, in terms of U.S. interests, I can think of no case for direct U.S. interest of more significance than reducing Poland's external debt burden on official debt.

Two things are clear: Every major government acknowledges, in private and now virtually in public, that this debt is totally unpayable. The Germans at the highest levels have told the Poles at the highest levels that they recognize that. The problem is that it stays on the books. We just postponed it again 14 months. And you know very well, because you first made the point, that postponing is not enough.

Now, the overhang will cripple the economic reform effort, because it stops foreign investors and the private sector dead in their tracks. "If Poland is bankrupt, how can we put new money in?"

This is a good area for the United States to move, because we hold such a small share of the debt. It is Germany and the other European countries that are the major creditors. They know full well that this cannot be collected.

This is the moment for a fundamental restructuring, to support the whole process of reform and democracy in Eastern Europe.

The United States does not have to lead, in the sense of either financially or actually in the process, because Germany should take the lead as Poland's major creditor. What we should do is signal our readiness to participate, and signal our very deep and profound interest in Germany taking the lead right now. In doing so and in encouraging the Germans, we should remind them of their own history in this century. When their debt was not forgiven, in the 1920's, it led to financial calamity and contributed to the rise of Hitler. After World War II we were smarter, and the United States led the effort, in 1953, to cancel half of Germany's official debt in the London Agreement of 1953.

So, West Germany has gone through deep debt-reduction. They know more than anybody how crucial it was for them to get a fresh start after World War II. Now it is time for them to lead the process. And we have the role of encouraging the Germans, as part of the whole reunification process and the political change in the region, to exercise their responsibility.

Senator BRADLEY. Thank you very much, Dr. Sachs.

Mr. Bergsten?

STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Mr. BERGSTEN. Mr. Chairman, let me add my word of praise to you for overcoming debt fatigue, holding these hearings, and taking a look at where we stand on the Brady Plan one year out and where we ought to go from here. I will emphasize in my remarks some proposed changes in the Brady Plan. I think a number of changes are required, and I will elaborate on them.

I want to make two preliminary comments. The first is to pick up on the last question in your letter of invitation to these hearings, where you stressed the need for the United States to ensure consistency in its own policies.

It seems to me, in that context, we have to remember that the largest debtor country in the world is the United States. The

United States is running the largest external deficits in the world. We are draining $10 billion per month of savings from the rest of the world.

I share your view, as indicated in your initial comments, that we should work to eliminate the negative resource transfer from the debtor countries. Indeed, in a book I wrote a little over a year ago I set that out as one very important policy objective, for debt reasons but also for U.S. adjustment reasons, which are some of the same reasons you were indicating. Unfortunately, not much has happened.

It is very hard for the United States to contribute to a reduction in the negative transfer from the rest of the world when we have to have a net positive transfer that is over $100 billion a year and, I'm afraid, is going to get bigger.

We know that the drug problem has a demand side as well as a supply side. The capital flight problem also has a demand side as well as a supply side. And as long as we have to have high interest rates in order to finance our own deficits, it is going to make it much harder for us to do anything for the rest of the world.

You have been a leader in trying to respond to that issue as well. I won't dwell on it, but I do remind you of it, because it really does set the framework in which we talk about Brady Plans, efforts to reduce the problems of Third World debt, et cetera.

There are two immediate implications. One, of course, is higher interest rates, and we are seeing that right now. Higher interest rates in Europe and Japan have driven up our interest rates, and since most of the external debt of the Third World is denominated in dollars, those higher rates immediately offset whatever we do through the Brady Plan. We can't forget that.

The second implication concerns trade policy. We know that, despite the Reagan rhetoric in favor of free trade, the Reagan policy mix—leading to an overvalued dollar and massive U.S. deficits—meant that we were pressured politically to put on more trade restrictions, as indeed the United States did through most of the 1980's.

Here I would give a pat on the back to the Bush administration. They have recently worked out some liberalizing measures with Mexico, in steel and in textiles, which look like they will expand Mexican access to our market for those products by something between half a billion dollars and a billion dollars per year. That is not insignificant in terms of Mexico's adjustment. I think that credit should be given to the Bush administration for seeing these kinds of linkages that you are talking about.

Nevertheless, as long as we run these massive budget deficits, suck in capital, and run huge trade deficits, the pressures are going to be there. Your emphasis on the Uruguay Round coming to a successful conclusion, I think, is critical. The United States has got to take a leading role in that. It is going to be harder to do if our trade deficit starts going up again this year, as you well know.

My second preliminary comment is to suggest that the situation in the debtor countries is perhaps not quite as bad as the conventional wisdom would have it. I think you have in front of you, Mr. Chairman, a study that my institute just released a month ago, written by John Williamson and based on an elaborate conference

we held in November, with papers on each of the major Latin American countries by experts from those countries.

If you will turn to either page 64 of the study or page 7 of the accompanying press release, you will see in one table a kind of snapshot of our analysis. What that table shows is 10 areas of policy reform, listed across the top of the table, that we think have been pretty widely agreed upon as making up the necessary policy reform package, ranging from fiscal discipline through privatization and deregulation.

What we did then was to ask to what extent those reforms are actually being put into place by the main Latin American countries listed on the left-hand side of the table. What you find is that Peru hasn't done anything—indeed it has moved backward; Brazil hasn't done very much; and Argentina is only beginning to do a bit; but most of the other countries to varying degrees have begun, encouragingly, to adopt significant reform programs.

The thrust of our study was the progress of policy reform and we found, somewhat to our own surprise, that in fact quite a lot of good programs are being put in place. And the countries are, at least up to now, sticking with them.

That, of course, is only part of the question, putting the right policies in place; the other issue is whether those policies have yet paid off. On page 66 we try to correlate policy reform with results, where "results" are defined as restoring growth.

John Williamson is a pretty tough grader, and he gave only Chile and Costa Rica high marks for having restored economic growth. I think one could argue that Colombia ought to be up in that upper left-hand corner; Mexico, with 3 percent growth last year and probably 4 percent this year, or more, ought perhaps to be in that column as well. There results indicate some reasonable correlation between adoption of reform packages and restoration of growth.

Having said that, there are still some countries—Bolivia, Jamaica, Uruguay, and perhaps some others—that have adopted policy reform packages but have not yet restored growth.

The message we drew from the analysis was that it takes some time—you have to be able to see the policies through, and that means you have to get external support and help for them—but that such a course is really the only one likely to restore adequate economic performance in the debtor countries.

So we were mildly encouraged that (a) reform packages have been adopted in most though by no means all of the countries; (b) there seemed to be results showing that those reform packages do make sense and can succeed; but (c) you have to stick to them for a while; and (d) those countries that haven't begun to move down that path, like Brazil, Peru, and to an important extent Argentina, need to do so.

But our analysis does lead us to a bottom line that says that things are happening. Perhaps the outlook is not quite as bleak as one would think. And there is, indeed, some hope if the countries can stick to their reforms, and, of course, if they get the necessary outside help.

That, then, leads me to the question of whether the outside help is right and adequate, and what changes need to be made in the

Brady Plan. I think the basic framework of the Brady Plan—the case-by-case, country-by-country approach and the provision of different possibilities for different banks, which, after all, do have different interests in the countries—is a proper framework.

I would take a more charitable view than Jeff Sachs did of the Mexico package. It does provide about $15 billion in the economic equivalent of debt reduction. Mexico has been able to get a sharp reduction in its interest rates, a good return of capital flight, a lot of private investment, restoration of growth last year and looking better this year, inflation down sharply, and a cut of about one-third in the interest bill. It is, admittedly, a case where one can say the cup is half full or half empty. I would have preferred more expansive outside help—that will in fact be the first reform I will suggest in the Brady framework. But I think the outcome looks reasonably good at the moment, and certainly the package has a good chance of achieving a successful restoration of economic growth and economic success in Mexico.

Let me say, however, where I think mid-course corrections are necessary. There are at least three or four key areas:

The first is that the Brady Plan, as I argued right from its start, is underfunded. Even if the framework is right, as I think it largely is, it does not have enough official resources committed to it to induce the necessary debt relief.

Curiously, that is not because of a lack of official funds. The World Bank just had a capital increase, and the IMF has $30 billion of liquid resources available and is about to get a quota increase. So one could take a greater share of World Bank and IMF resources, earmark them for support of debt relief programs negotiated a la Mexico under the Brady Plan, increase thereby the inducements to the countries to participate, reward them more effectively when they deserve it, as in Mexico, and increase the chances for a successful outcome.

Our estimate in the new Williamson study and in an earlier work we did is that a total resource commitment of at least $50 billion, rather than the $34 billion actually committed, is needed in order to ensure a reasonable chance of success for the Brady packages; $6 billion was used in Mexico; that takes the total down to about $28 billion. That could be used up very rapidly if we get effective reform programs in Brazil, Argentina, Venezuela, and the list of smaller countries that Jeff Sachs has referred to.

So I would stress the need to increase the amount of funding available under the Brady Plan.

Now, to go back to my first point, the United States is a drainer, not a contributor; we are not going to put up the money in any bilateral way instead; we are going to continue to lean on the Japanese, the Taiwanese, and the other surplus countries to do it. But the money is mainly going to come from the multilateral institutions. I think that is proper, because it links the relief to the reform programs. It is proper for the multilaterals to be out front. We should be behind them, supporting them strongly. But bigger amounts of money would be my first proposal, and I think the money is there and should be earmarked for these purposes.

Second, there is a peculiar technique that is being used in the international financial institutions for implementing their part of

the Brady Plan and using these resources that they have earmarked for it. There is one pot that is usable for reduction of the debt principal—actually cutting back the amounts of debt owed. And there is a completely separate pot that is used for interest support, for reducing debt-servicing costs. The two pots are kept separate and can only be used for the individual components of the deal.

In Mexico that did not turn out to be a problem; because the banks chose roughly equal amounts of debt relief and debt-service relief, both pots were fully used. But in the Philippines, one reason the package was inadequate in magnitude is that part of the money available from the multilateral institutions was not used. The Philippines and their banks chose mainly to use buybacks and reduce the debt principal. There was no debt-service relief. That means only one of the two pots available from in the institutions was available; the other was not.

Obviously that money should be made fungible. Whatever the package worked out between a country and its creditors, that country should be able to use its share of the total pot. That Chinese wall should be broken down, and the amounts already available could then be used more effectively and more adequately.

Third, I would put increased emphasis in future programs on direct buybacks. The Philippines chose that route. Jeff had some criticism of it, but I think that approach has some merit, and I note that Poland is indeed proposing to use the buyback route for its commercial bank debt to try to deal with that part of its external debt problem.

There are a couple of reasons why buybacks are attractive. First, one gets more leverage for the money. The secondary market price of Brazilian and Argentine debt is now something like 20–25 cents on the dollar. Therefore every dollar that can be garnered from the World Bank and the IMF and used for direct buyback is going to reduce the debt at a 4:1 or 5:1 ratio.

Some have worried that such a program will drive up the secondary market price. That actually did not happen to any significant degree in the Bolivian case, the Costa Rican case, or even the Philippines case. So I am not sure that that is a big problem. One would have to worry about that possibility, but I think that even if there were some modest increase in the price, the leverage you would get from direct buybacks would still be substantial.

In addition, buybacks involve much less hassle. If a country offers to buy back its debt and there is the requisite official pressure to get the banks to play—and I fully agree that would be needed—if you get those two things into the pot, then I think it can be done quickly, and it can be done with much less hassle.

The Philippine deal was done in a week or two, compared with the year-plus that it took for Mexico, and it seems to me that is very advantageous in terms of avoiding the lingering uncertainties in the markets and the negative effects on future possibilities for borrowing—not just from the banks but from private creditors, direct investors, the whole crew that you are going to have to rely on in the future in any event.

So that would be the third change that I would propose.

Fourth, I would agree that we need some increased contribution from the official lending agencies to the debt-relief packages. And here probably the most likely candidates are the export credit institutions, like our own Export-Import Bank.

Immediately that raises questions from a public policy standpoint of whether we want to give debt relief from government lenders. But if we are serious about debt relief, then countries where official creditors make up an important part of the overall package do, I think, have to face that issue squarely.

Fortunately, our own Export-Import Bank now, like most of the commercial banks, has reserved against some of these credits and therefore has taken at least the first step in that direction.

A contribution of debt relief from the public creditors, particularly the export credit institutions, would obviously add a significant plus to the overall packages; it would add further to what I was suggesting before, in terms of increasing official resources available to reduce debt relief in total and, most importantly, support the program of the debtor countries.

[The prepared statement of Mr. Bergsten appears in the appendix.]

Senator BRADLEY. Well, let me thank all three of you for your testimony. I think it was full of a lot of very helpful thought and recommendations as well as observations about what has transpired in this area since the Brady Plan was announced.

One of the things that strikes me is that the use of "debt fatigue" not only illustrates the extent to which this issue has been around for a long time but also, perhaps, the sense of urgency that appears to be absent in the official negotiating avenue.

I wonder if there is any suggestion that you have that you think might focus the attention of our government more directly on the series of challenges that confront it. I have suggested the appointment of a "debt ambassador" as an impartial mediator to focus attention on this issue and to drive the bureaucratic process. Do you need a joint IMF–IBRD department? Do you need a select group of international experts to form some kind of panel with the banks and creditor government? Do you have any ideas of how to re-invigorate this process with a sense of urgency, that the numbers Mr. Tucker gave us at the beginning clearly illustrate a need for?

Mr. BERGSTEN. I guess I am modestly more optimistic than your premise would suggest. I think one or more of those procedural steps that you suggest might be desirable, but I don't think that in and of themselves they would get the focus that you want. It seems to me that goes back to substance.

I was reasonably impressed by the reception that Brazilian President-elect Collor received when he came to Washington just a few weeks ago. Certainly the words that he conveyed to the audience here indicated that he was serious about putting an important, major reform program into place in Brazil as soon as he took office. The words he got back, I am told by top officials of the administration, including at the very top of the administration, were that the United States would respond very substantially and very quickly to a program of that type.

I tend to believe that the focal point has to be the debtor countries themselves adopting reform programs that are then worthy of

support. When Mexico did that, it got substantial support. Admittedly, Mexico is the most important of the debtor countries to us and so is going to get more focus, but Brazil is critical as well. Argentina, I think, as evidenced by some U.S. support for its inadequate steps back in 1988, does get responses.

I think if the countries of Latin America—particularly the two big countries, and particularly Brazil when its new administration comes in—do indicate by actions in addition to words that they are willing to get serious about its economic problems, that it will galvanize a constructive, major response here, and that will renew the kind of emphasis that you want.

I think it is probably going to have to occur on a country-by-country basis and be responsive to initiatives that they take in the first instance.

Senator BRADLEY. Dr. Sachs?

Dr. SACHS. Well, I think this is the ideal time to get the attention of the administration, because they're requesting a quota increase for the IMF, and the IMF is the central institution involved in this process—necessarily so, and properly so. And the IMF should be the one that plays the core role in this process, because this is not basically a U.S. responsibility, it is a global responsibility. It is the responsibility for international monetary stability, and so it falls directly within the competence and purview of the IMF.

But the IMF was taken out of the process in one important way, last March, because in the Brady Plan, one of the substantive points was the Treasury Secretary said, "We don't want the IMF saying how much debt reduction is needed." This put everything into a very strange process, in that you have extraordinarily detailed, not always correct, in my view, but very competent technical analysis of capacity to pay debt service, and so forth, and then the negotiations go on as if that doesn't exist.

There is a way to bring that back, which is to have the IMF define the extent to which debt reduction is needed in a country, and then to have the IMF lead the process of getting an adequate package, with some idea of what "adequacy" means.

I think what is required for the United States is that we give the IMF that task. The way to require that, it seems to me, is for the Congress to recognize that not to give a blank check but to say a quota increase—which is very important and which I support—should come if the IMF is an effective institution. And its effectiveness has very much been undermined by this process dragging on.

So, the administration should present a plan to the Congress, it seems to me, as part of the quota increase, for how you are going to get off square-one for these 35 other countries, for what is a systematic way to proceed.

Senator BRADLEY. What would be the criteria that you would lay out?

Dr. SACHS. The criteria for how much?

Senator BRADLEY. In other words, you suggest that, as a condition of the quota increase, there has to be a plan for systematic debt reduction that could apply to any of a number of other countries—maybe not all 35, but many.

Dr. SACHS. Yes.

Senator BRADLEY. So, my question is: What might the outline of that plan be?

Dr. SACHS. The outline of the plan, it seems to me, is that the Treasury explain how it is going to be, that the IMF analysis of debt-service capacity is put in the context of the negotiations, and how it is that the Treasury is going to regard the step of the process—if the banks do not accept that plan, what the response of the official community will be to arrears.

Because, while I agree with you, Senator, that arrears is not the optimal way to proceed, I can sure tell you it's a damn bit better than creating a hyperinflation because you continue to service debt to recalcitrant banks.

Arrears is the only safety valve that we have, because if the banks don't give, there are two things that can happen: one is a hyperinflation, and the other is arrears. And under the circumstances, arrears provides a safety valve. Sometimes you get arrears plus hyperinflation.

Now, I think what the Treasury has to do is outline how is the amount of debt reduction, what is judged to be adequate, going to be set? Because they can't, must not, come back again and say, "Well, let the market do it," because it is so grossly illogical and so clearly not the market working that they should not talk to grown men like that—men and women.

Senator BRADLEY. Could you draw clearly the relationship between the debt burden and hyperinflation?

Dr. SACHS. Yes. The debt that these countries are confronting is overwhelmingly public-sector debt, and that means that it is a direct burden on the public finances.

In some cases it takes 30 percent of the budget, in some cases 50 percent, in some cases 75 percent of the budget, were the interest to be fully serviced.

Governments that are so stretched and have large deficits because of the interest burden either have to go and buy foreign exchange from their private exports, to get the foreign exchange to make the sale, and that creates money by printing money to buy the foreign exchange; or they use the government foreign exchange earnings, if it is a State enterprise ownership, to pay the debt, instead of selling that foreign exchange earnings into the private market, to private importers, and thereby sucking up the money supply.

So there is a very one-to-one and immediate link between an external debt burden to a government and the amount of money that is printed, which is why the reparations payments in Germany triggered the German hyperinflation and which is why we have seven hyperinflations in this decade, all of which were to heavily-indebted governments. It is a very direct and mechanical link.

Senator BRADLEY. But we don't have a hyperinflation here.

Dr. SACHS. Because Japan continues to lend to us, and the private markets continue to lend. And what you saw in all of these countries is that the hyperinflation starts when the normal lending stops. So when the bank lending stopped, then the governments had to cover, and the burden of the debt went up because of the higher real interest rates. Then, instead of an inflow of foreign ex-

change, there was the outflow. You couldn't cover your deficit by dollar borrowing, you had to cover your deficit by peso printing.

Senator BRADLEY. If you took your thought process forward, if the foreign creditors of the United States ever ceased to provide the capital, then this would lead to hyperinflation?

Dr. SACHS. Well, hyperinflation generally depends on two things, or three things: It depends on a deficit that is much larger than we have as a proportion of income, generally about 10 percent of GNP. And ours, mercifully, has come down to about 2.5 percent.

Senator BRADLEY. So, the economy, even in the present state of vulnerability, as Mr. Bergsten has said, is still infinitely better managed than a lot of the economies where the public-sector debt has reached 10 percent of GNP?

Dr. SACHS. Without question. That is right. Where the public-sector deficit has reached 10 percent of GNP.

Senator BRADLEY. Mr. Bergsten?

Mr. BERGSTEN. Could I just pursue your line of questioning a little bit, though, because I think it is terribly important, and put two questions to Jeff?

Senator BRADLEY. Go ahead.

Mr. BERGSTEN. One is that there are a lot of countries with big external debt that have not had hyperinflation. It is clearly not a necessary follow-on that you get hyperinflation from external debt. So that is question one: Is there really a linkage, from debt to hyperinflation?

Second, some of the countries that are big debtors and have hyperinflation haven't been paying their debts anyway. The Argentines haven't paid anything on their external debt for at least the last 2 years; so that has not, in any direct sense at least, led to money creation and the effect that Jeff mentioned.

Senator BRADLEY. I guess one might say, though, the existence of it.

Dr. SACHS. Let me answer, if I could, Fred.

Mr. BERGSTEN. But those are key to getting it out on the table.

Senator BRADLEY. Let me take Mr. Bergsten's questions to Dr. Sachs and ask Dr. Sachs if you would answer Mr. Bergsten's questions.

Mr. BERGSTEN. I will do that.

Dr. SACHS. I appreciate that, Mr. Chairman.

Mr. BERGSTEN. Thank you.

Dr. SACHS. If you could convey to Fred the following—[Laughter.]

Hyperinflation is a very complicated process. The foreign debt gets it started almost inevitably. But in Argentina—and it was the same in Bolivia, actually, as well—the hyperinflation is corrosive of tax collections and corrosive of faith in the domestic money, so that even if the debt is the process that starts the thing off, by the time you are in a full-fledged hyperinflation, the tax system has collapsed and the faith in holding money has collapsed, so that you are in a state of flight from domestic money and open deficits for reasons that weren't even there to begin with.

Moreover, one of the big mistakes we made in this decade was to say, "No problem. All of these countries can pay their debt." We knew that it wasn't true, but one of the things they did for 10 years was build up internal debt, to borrow internally to make the

external debt payment, to the point where the banks now say, "Well, why do you complain about the external debt? It is the internal debt burden that is so big." And what a phony line, because the internal debt was only accumulated to pay the external debt.

So, Argentina got into a terrible internal-debt problem, and Brazil is in a mammoth internal-debt problem, because of the process that, instead of just printing money to pay the foreign debt, they borrowed internally for a while.

So, what I would say to Fred is, it is not a sufficient condition to have a hyperinflation, but it is an enormously and historically significant stimulant to a hyperinflation. And to end a hyperinflation, the debt burden must come off.

Now, for a while it can come off just because of the standstill. The debt sits there, and you don't pay. And that's how Bolivia did it. But eventually you have to get it off the books if the country is going to have a future again.

Senator BRADLEY. Mr. Bergsten made a number of suggestions for changes in the Brady Plan—increasing official resources; eliminating this two-pot international financial institution approach; more direct buybacks; and the need to increase official resources, in particular related to export credits. Those are your suggestions, Mr. Bergsten.

Mr. Tucker, do you agree with these suggestions? And could you add any other specific recommendations for changes in the Brady Plan? And then, Dr. Sachs.

Mr. TUCKER. Well, I have to plead a large amount of ignorance about the Brady Plan and specific mechanisms of debt relief.

Senator BRADLEY. Fine. Do you have a more general comment?

Mr. TUCKER. Yes, just a general comment about the link to the U.S. economy on capital flows.

We clearly have the choice, if the Japanese stop lending to us: we can either print money and have hyperinflation like Latin countries often do, or we can simply immediately slash our public deficits, go into a public surplus, to overcome the fact that we no longer can borrow from the Japanese.

What we find, of course is that Latin American governments have very little capacity to make those kinds of radical changes. We may have that capacity, but we haven't been tested. And I think that is why there is a stronger link with the Latin governments, because of the political intransigence; whereas, other countries around the world may have been able to cut their public deficits quickly in response.

Senator BRADLEY. Dr. Sachs?

Dr. SACHS. I think Fred's points are useful, but I don't think they reach the central point.

Senator BRADLEY. So you would add a fifth, or a sixth?

Dr. SACHS. Yes, comprehensiveness in the settlement.

Senator BRADLEY. That is the point about a systemic approach related to—go ahead.

Dr. SACHS. Right, how much is needed. It should be country by country. We shouldn't bring in, as some will, that when you say "systemic," it means somehow not case-by-case. But it means looking at what the country needs, and then insisting that the settlement meet that level, and then trying to impose that on an across-

the-board basis, equal-effort basis, backed up by the notion that arrears is the safety valve, in the end, if you don't reach that level of reduction.

Senator BRADLEY. When you say "equal effort," do you mean each bank assuming the proportionate share of reduction?

Dr. SACHS. Exactly, a proportionate reduction.

Senator BRADLEY. And you differ, in that you would not offer new money as a part of the menu? You seem to be negative on the menu.

Dr. SACHS. Yes. I think we see that new money is only desired by a very small percent of the banks, but it leads to an enormous and endless wrangling in the negotiations. And it is not appropriate, actually, to both force banks to reduce the debt and to give new money. This has been one of the major problems in selling the whole approach of the Brady Plan, why there is so much confusion in Europe and Japan about it, and anger about it, in many governments.

Senator BRADLEY. Yes. So, basically, you agree with the four points, but you would add the fifth.

Dr. SACHS. But let me add that how much official money you need depends on how you do the negotiations. There is a real danger.

I am not really so upset about how much official support there is for this process, in the money side. Perhaps some more would be useful. But I am very concerned about adding new public funds without the pressure on the other side, because I think that will slow the process rather than improve the process. In other words, it is a question of how the pressure is effectively applied, not how much official money we put in to get the agreement done.

Senator BRADLEY. Mr. Bergsten?

Mr. BERGSTEN. Actually, what Jeff is suggesting and what I suggested are not that far apart. But there is one crucial point: he uses the word "comprehensive," not to mean it covers all countries but, as he said, to——

Dr. SACHS. Cover all banks.

Mr. BERGSTEN [continuing]. Cover all lenders in a given country.

Of course, I am for that, too. The question is, how do you do it? I fully agree that IMF analyses should be used more centrally in the process. There is no difference between us on that.

The question, really, is the old one that has been debated throughout this discussion over the years, namely, do you adopt some kind of mandatory approach, or is it still a "voluntary one?" We have to say "voluntary" in quotes because, as Jeff said in his original comments, there is of course enormous arm twisting.

I don't think there has been that much free riding. Everything that we have written at my institute harangues against the free-rider problem. There are a few people, maybe, in some cases, that have ducked out, but I think it hasn't been quantitatively significant. Most of the big players, one way or another, have gone along with these programs.

So the issue is whether you think that is really adequate, recognizing that it is messy and perhaps time-consuming, or whether you and the Congress want to vote something that requires debt reduction—whether you want the IMF to implement, through some

of its provisions, a mandatory system. But that would have to be backed up by the U.S. Government, the Congress, and everybody else involved.

How would you make it comprehensive?

Senator BRADLEY. Right.

Mr. BERGSTEN. Jeff says the new money side of it leads to enormous wrangling. Well, I'm not particularly in favor of new money, but if different banks want to do it different ways, and some want to provide new money, I don't object to that. Not many do. It didn't lead to much wrangling in the Philippines case; they got a fair dollop of new money, and it was done in a week or two. I don't see a lot of wrangling. The wrangling was over the complicated mix of instruments for debt reduction.

One could perhaps find more effective ways to do that; a central director of the type you suggested in your first question might be one way to do it. But short of going to some kind of literally mandated, legislated requirement, I don't see much practical alternative to the way it is being done now.

I did suggest more use of buybacks, which I think would have much less wrangling.

Senator BRADLEY. Dr. Sachs, I think, thinks there is a way, short of those things you suggested. Take your hit, and then we want to move on.

Dr. SACHS. One can get an agreement in a week, if you don't want very much, which is what the Philippines is all about. So, I think, let's put that aside.

Legislation is a red herring; this is a policy decision within the International Monetary Fund that is required. They have the authority to play a more central role, if we want it. It is a choice of our Treasury and the other treasuries that constitute the voting majority of the International Monetary Fund.

Senator BRADLEY. And that they would do what?

Dr. SACHS. What they would do is allow professional assessments of the depth of debt reduction, make those an explicit part of the process, be able to tell the board that a given agreement, under the following detailed analysis, provided, will restore the debt:service ratios permanently to a level of so-and-so by within 2 or 3 years, that kind of thing.

There are ways to judge, and many indicators—the secondary market, debt:export ratios, debt:service ratios—that provide indicators of whether a country, by 1992 or 1993, will be "viable," which is the technical term that they use. "Viable" means will be able, on a permanent basis, to sustain its debt-service burden without emergency measures like reschedulings.

So they make such analyses. They play absolutely no role in the negotiations right now.

Senator BRADLEY. Let us say they do the analysis, and they point out that country X should have X, Y, and Z.

Dr. SACHS. Yes.

Senator BRADLEY. Who comes to the party?

Dr. SACHS. Who comes to the party, then, I think in practice, is that the basis of the negotiation, the starting point, when the IMF goes into the meeting between the steering committee and the country, and the IMF is present, it says that the governments of

the creditor world, operating through the technical staff of the IMF, "judged that the amount of debt reduction necessary here is on the order of 50 percent, and we think, for this program to be successful," and so forth," that is the amount of debt reduction that is necessary. We think that the countries cannot afford to pay more of the debt without deeply jeopardizing the reform program."

And, tacitly, what is meant is that if the banks do not meet that level, there would be expected to be arrears accumulating to the extent that the debt-reduction package doesn't work.

Now, the practical import of the arrears question is very great. Because, with no new legislation, if the official community says, "Look, Bolivia can't pay a penny of its debt," which they do now say, "and we are never going to ask them to, because we don't believe they can pay a penny of it."

It changes the whole nature of Bolivia's international relations, and in a very favorable way. They get IMF programs, they get World Bank programs, they get Paris Club, they have all of their official relations on good terms, and the debt is more or less just totally put off to the side.

Eventually, if that is done, the banks will make a settlement, because it will be in their interest to clean it up, also.

Costa Rica had its arrears for 3 years, and the Costa Ricans will tell you, the reason they got a decent agreement is that the International Monetary Fund essentially told the banks, "Look. Those are Costa Rica's needs. We are not going to support you in the process to put undue pressure on that country, and thereby destabilize them."

So I think the process could be very much deepened without any U.S. Senator having to vote that any specific bank brings down its debt any specific amount. In other words, the process could be moved in a far more systematic way, if we chose to move it that way.

Senator BRADLEY. The fourth suggestion you made, Mr. Bergsten, was that there has to be greater involvement with export credit institutions; and yet, you observed that the Ex-Im has recently reserved about 25 percent of their outstanding loans. The question is, what is the implication of that?

Mr. BERGSTEN. Well, they have reserved, as the commercial banks have——

Dr. SACHS. You mean reduction of official export credits.

Mr. BERGSTEN. Yes. I was going to say, they have reserved against a possible future reduction in their claims, but they have not reduced the claims. They have not given any debt relief. They have arrearages, just as the commercial banks have arrearages, so now they have gotten to a position where they have to reserve against the possibility that those debts will never be paid. But they have not reduced their claims; they have not offered any relief.

My point was simply that, having taken the reserving step positions them much better, as Jeff said is the case for the commercial banks, to take that next step and offer debt relief as part of a program.

Senator BRADLEY. So you don't see that as a problem? You don't see that as a fact that reduces the Ex-Im's flexibility or potential role in this?

Mr. BERGSTEN. I think it is a very grave issue, as I mentioned in my original comment, for a public institution as well as a private institution to write off its claims. In the case of the Eximbank, when they come back to you in the Congress, then, for support the next year, I am sure the point is going to be put forward.

Senator BRADLEY. I mean, for instance, there are always suggestions that we should expand Ex-Im financing for X, Y, and Z. It is like saying, if you are on the board of directors of a bank, that you should increase your loans to X, when you haven't managed your existing portfolio well. That is what it basically says. It says, "You basically have made loans that demonstrate incompetence."

Mr. BERGSTEN. Well, it may say that. It also may say that situations changed in an unforeseeable manner for the Eximbank, as well as for the commercial banks, as well as for the IMF and the World Bank themselves. Everybody has loans to these countries that they made thinking they would be repaid, or at least serviced. The world changed in the 1980's. That affects the export credit agencies as well as private institutions.

I would not expect them to put new money into the same country where they are now writing off a loan, but I would expect them to continue putting new credit into other countries and diversify the portfolio.

Senator BRADLEY. If I can, let me shift subjects to Eastern Europe. In the context of our discussion about Third World debt, do you think this greater interest in Eastern Europe, in terms of the destination of capital, is going to divert resources from Latin America? Are you concerned about that, Mr. Tucker?

Mr. TUCKER. I am concerned about the attention to Eastern Europe on two levels: One is the private capital flows, but the second level is official attention.

Turning to private capital flows, the problem with Eastern Europe is that it very much is an economy that doesn't function. The bureaucratic mechanisms of the state-run enterprises are going to take some time to straighten out, and that is going to be even worse in the case of the Soviet Union than in parts of Eastern Europe where they have begun to do the process already.

I think there is a lot of optimism in the business community that there will be business opportunities immediately; but the bottom line is, it is going to be years before American businessmen go in, and I think the Europeans will only go in as a sense of political attachment rather than profit motive.

Senator BRADLEY. So, you don't fear that here we have this large area, large population, massive needs for capital? You don't believe that a large flow to Eastern Europe will present problems for less-developed nations?

Mr. TUCKER. I hope that they are capable of absorbing the money, and in fact it would happen, and consequently, I would fear for Latin America. But I am pessimistic about Eastern European economic change being quick and efficient. I think they are going to run into many problems and that they won't be able to absorb the capital that we have out there waiting for them.

Germany is going to have to put in a lot of money. A lot of other people are not going to. The Japanese don't know enough about Eastern Europe to know what to do with their money.

On the official side, there is a different attention, though, and that is that the U.S. foreign aid budget is extremely stretched right now, and much attention has now focused upon what can we do for Eastern Europe.

Unfortunately, the suggestions are to try to either unlock the Arab-Israeli deadlock in our foreign aid budget, which doesn't seem likely, or to pull money out of our development aid for Africa and low-income countries around the world and put it in Eastern Europe. I think that is the wrong priority choice.

The money that should go into Eastern Europe should come directly out of the peace dividend of the defense budget. The foreign aid budget is already thinly stretched; only about $2 billion go to low-income, needy causes; the rest of it goes to security causes or countries with higher incomes.

Senator BRADLEY. Dr. Sachs? Mr. Bergsten?

Mr. BERGSTEN. I'll give you a twofold answer, very quickly. In the short run, I think there will be a diversion. There will be capital flowing into Eastern Europe, both public and private, and I think that will divert capital from other parts of the world.

However, if those investments succeed, and Eastern Europe achieves anything like the reforms we hope, it will give a new impetus to world growth. It will create increasing markets. And, over time, by generating increased growth, increased markets, and maybe new sources of capital, it may actually help. So, I would make a timing distinction—in the short run, yes.

Senator BRADLEY. In what period of time?

Mr. BERGSTEN. Well, it is going to take a while, as Mr. Tucker said. But, in these terms, if there is a lot of capital infusion, there could be a lot of increased economic growth, which already would start providing markets within the next couple of years. I would not be surprised at that.

But the broader point I want to make is the following: I think Europe as a whole, Western and Eastern, taken together, may turn out to be the main magnet for world capital flows in the 1990's. In the 1960's, international capital flows went largely to Europe, when the Common Market was first created, when it had growth in excess of 4 percent a year, when there was a lot of labor moving into the area to push its growth rates to very high levels. They grew faster than we, and Asia was just coming up.

In the 1970's, world capital flows went to Latin America. We have been talking about the aftermath of that today. In the 1980's, world capital flows came to the United States. My guess is that in the 1990's it is going to go back to Europe, out of a combination of the economic unification of Western Europe, the accession of Eastern Europe, and the outbreak of peace, which reduces the one big hangup people might have had about Europe's economic future in the postwar period to date.

So I expect rapid economic growth, lots of investment, and of capital moving into Europe, which is then going to make it harder for everybody else, ourselves included, to maintain the capital inflow that we need. I think that is a change in the global macroeconomic picture that is going to have a big effect on all of us.

Senator BRADLEY. And have a direct effect on our own domestic interest rate situation.

Mr. BERGSTEN. We are beginning, already, to see that. I think it is going to escalate in the 1990's and impact on U.S. interest rates. In fact, neither fiscal changes nor hyperinflation are going to be the main result in the United States. It is going to be higher interest rates, constantly tighter monetary policy than we need for domestic reasons, ergo slower economic growth.

Senator BRADLEY. So, we are caught between the need to expand for domestic reasons and the need to be a little more conservative for external reasons?

Mr. BERGSTEN. I think this may be the manner in which the chickens of the 1980's come home to roost in the 1990's.

Senator BRADLEY. Dr. Sachs?

Dr. SACHS. Well, it is very hard to give an answer with a lot of assurance to your question. But I actually doubt the macroeconomic significance as being overwhelming. I think the region of this 120 million people is too impoverished to have an enormous macroeconomic effect. The total GNP for that area is probably the size of a few large American cities right now, not something that is going to be overwhelming in significance.

I suspect that any reasonable reduction of our budget deficit would greatly overwhelm—another $20 billion of savings would overwhelm—the macro significance of the flows in the next couple of years. So, I don't see that as the central issue.

On the use of the budget, though, there is a problem, and I am worried about diverting money from very poor countries to anywhere, whether it is Eastern Europe or anywhere else. And I think we are remiss to think that when we are already ranking 23 out of 24 of the industrial world in the share of GNP we give to foreign assistance, that the only pot that we have is that amount of existing money.

I would stress the peace-dividend aspect. I thought President Havel—fortunately, he said it perfectly—he said it right: the millions you send to the East will come back as billions in savings to the West. And I cannot think of a better investment right now of our budget funds. If we want to make the peace dividend secure, make the reforms work, and this is the moment to do it. And it is a time of rather urgent need.

Let me finally say, because I think it is rather striking to know, as to the Japanese: It is not that they don't know what is going on in Eastern Europe; it is almost exactly the opposite. I just thought it would be interesting for you to know they are all over the place. American business is not. They are trying to compete not only in Czechoslovakia, Hungary, and so forth; they have made an enormously determined effort and systematic effort in East Germany, no less. So they go right to the heart of Germany and want to outcompete with the West Germans.

Senator BRADLEY. When you say we should use the peace dividend to help in Eastern Europe, what, specifically, do you suggest we do?

Dr. SACHS. Well, let me say, the peace dividend is on the order of tens of billions of dollars. And I think an additional billion dollars, if well-spent, can have a profound effect.

Senator BRADLEY. That is my point. "Well-spent" means what?

Dr. SACHS. Well, in the context of Poland, for example, there is a desperate, indeed urgent, need right now for technical assistance, of management consultants and accountants, and so forth. The Poles have called for a major source of support, and the administration says, "No, we can't come up with $100 million right now."

Senator BRADLEY. This is essentially money to pay for U.S. accountants and business consultants to go to Poland to live for a year?

Dr. SACHS. Right now, as Poland, under this reform program, gets into an enormous crisis, one thing that is being found is that the firms that are producing things that could be sold in Western Europe don't have the mechanisms to make the slight design changes, to find the markets, to find the hook-ups, and so forth. So, strange as it may sound, one could have an enormous effect right now with management advice.

Senator BRADLEY. Right. Like, for example in Poland, if you had a lot of tractors, and all they needed was a part——

Dr. SACHS. That is the kind of thing.

Senator BRADLEY. Being aware that there is a part, and having access to the part, and having the funds to buy it. Right?

Dr. SACHS. Senator, I sent some management consultants to Poland a couple of weeks ago. They had never seen the likes of such people before. When they heard that you could actually study the Western European markets to know who to hook up with, these firms were astounded, because these enterprises had not seen the light of day in 4 years.

Senator BRADLEY. All right. So, other specifics? Technical expertise, experts, middlemen?

Dr. SACHS. Right. That is one thing.

For other countries, we should do what we did for Poland last year, which is to give a fund to allow for convertible currencies. We gave $200 million, leveraged up to a billion, to help Poland start off with a convertible currency—fundamental to the economic reform effort.

The same thing should be done with Hungary, the same thing should be done with Czechoslovakia, the same thing should be done if Bulgaria and Rumania ever get together to do this. Small amounts of money, leveraged five times as we get multilateral participation, could help establish these countries on a free trade regime, which is fundamental for their future health. That is the second area that I would recommend.

Senator BRADLEY. Would you be interested in a free trade area with Poland?

Dr. SACHS. Poland and all of these countries should have an association status with the European Community, negotiated as soon as possible, so that there is a reciprocal free trade with the rest of Western Europe.

Poland, in a few weeks, is going to sit on the border of the European Community, which I guess is moving East fairly quickly right now, and Czechoslovakia and Hungary already do. For those countries, there is nothing more fundamental to the long-term success, nothing, than proper integration with Western Europe on a free-trade basis.

And the second thing that is needed is to get rid of the debt overhang which will cripple their future. Those two steps are the most important steps.

The third step is emergency financial support, properly directed, to get them through the difficult transition period.

Senator BRADLEY. What for?

Dr. SACHS. The emergency?

Senator BRADLEY. Yes.

Dr. SACHS. Balance-of-payment support for creating convertible currencies, support for the technical assistance, which is costly but which must come on in a large scale, not a trickle of people going over there, but in a large scale—partly, by the way, to get American business involved far more than it is right now.

Senator BRADLEY. Right.

Dr. SACHS. And finally, there are needs which are very important but collateral to the direct economics, such as support for democratic institutions.

Senator BRADLEY. We are heading toward the conclusion of this hearing, and I want to try to get a couple of points through. So, if you could try to be brief and hit your high points, I would appreciate that.

Fred, do you have any response to the question that Jeff was addressing, in terms of Eastern Europe, what we need to do to get things started in Western Europe?

Mr. BERGSTEN. No. I endorse what he said on Eastern Europe, and I particularly endorse early association with the Common Market and extension of trade preferences from here, to try to give them a shot at entering world markets as fast as they can.

Senator BRADLEY. Should the United States negotiate a free trade area with Poland?

Mr. BERGSTEN. I do not think so. I think that would divert them from the major markets they need to address, which are those of Western Europe, and I think it would send a wrong signal in terms of our overall trade policy. But preferential access, yes.

Senator BRADLEY. Do you mean Most Favored Nation?

Mr. BERGSTEN. Right.

Senator BRADLEY. Now, tell me what you think a one-to-one East German-West German mark will mean. Give me the five key points. What will it mean to Germany? What will be the implications for Germany, internally?

Mr. BERGSTEN. One, I think in the short run it will mean quite a lot of inflationary pressure on the German economy as a whole.

Two, given the Bundesbank's policy, that will mean considerably higher German interest rates as a whole.

Three, because of the interdependence of global financial markets, it will mean higher interest rates here and around the world.

Four, they could avoid that if they would do it in a somewhat slower, more orderly way, where investment and supply-side measures increase the output capacity of East Germany before the monetary overhang is permitted to descend. That is what the Bundesbank wants to do but what politics are going to override at the end of the day.

And five, since I expect Germany to be unified soon and financial integration to be part of that, I think one through three are going to happen.

Senator BRADLEY. And you think all of the adverse repercussions, in terms of the interest rates, et cetera, would occur even if the one-to-one applied to only a limited amount of German savings?

Mr. BERGSTEN. And even if they freeze the release of those, because financial intermediaries will lend against that collateral just as they do against life insurance——

Senator BRADLEY. So, that is not a way out?

Mr. BERGSTEN [continuing]. And annuities here.

Senator BRADLEY. So, you see higher German interest rates as inevitable in the next year?

Mr. BERGSTEN. The answer to that is yes, even without monetary integration with the East. Monetary integration with the East, I think, will add to it, if they proceed pell-mell as I think they are doing.

Senator BRADLEY. Okay.

Does anyone else on the panel want to respond to that one-on-one?

Mr. TUCKER. There will also be significant trade shifts. East Germany will suck in a lot of West German goods, which will change West Germany's balance of trade with the rest of the world.

Senator BRADLEY. So their export surplus will drop?

Mr. TUCKER. Definitely.

Senator BRADLEY. Dr. Sachs?

Dr. SACHS. I think that the right way to think about it is, they will sterilize a great proportion of this money exchange, and it becomes an addition to public debt in Germany of some tens of billions of dollars, probably.

That will have some effects, but, again, I would doubt at this point—although, again, no one has finished a detailed analysis—I doubt that that will have a very strong effect throughout the world.

I think, in other words, that the procedures will not be to just print 100 billion deutchmarks and exchange it for 100 billion eastmarks, and have an enormous increase in the money supply. The amount of actual money that is put in will respond to the transactions needs in East Germany, and the rest will become a form of savings bonds. Essentially, you will lean on the West German government. And increasing the amount of public debt in one shot, I don't know offhand the number, maybe by 5 percentage points——

Senator BRADLEY. So, you mean there will be less German marks for the U.S. budget deficit and more for the German?

Dr. SACHS. It will increase their public debt. That is right.

Senator BRADLEY. Which could have the same effect.

Dr. SACHS. Which could, but, adding 5 percentage points of public debt or 8 percentage points of public debt, I don't think, will have a—it does make monetary policy far trickier to manage, so the chance of mistakes and problems is much greater. And I would say that the volatility of the international markets will increase, because hitting this exactly right is pretty complicated.

Senator BRADLEY. One last question: The Germans have just recently forgiven a billion dollars in a government-to-government

loan with Poland. They have been reluctant to do anything with the Paris Club. What does that imply? Read the tea leaves.

Dr. SACHS. Well, Germany knows, the banks and the government know, that Poland's debt is unpayable, and they have told the Poles as much. They have shown the willingness to do a bit, and I think that was a good start, what they have done. But the key is to do something meaningful and comprehensive.

It should be done in the context of the EC, not of the——

Senator BRADLEY. But why are the Germans not going to say, "Okay, fine; let's go to the Paris Club?"

Dr. SACHS. The Paris Club, per se—first, it is not their venue; it is in Paris. And second, the Paris Club is bound by all sorts of precedential rules. An effort can be launched outside of the Paris Club, and it should be launched by the European Community, not inside the Paris Club.

So, the Germans can be pressed, I think, to take proper responsibility and to find the right mechanisms.

Senator BRADLEY. You don't read into this any kind of unilateralism?

Dr. SACHS. I think it was a gesture, because they know that writing down a billion deutchmarks or a billion dollars of debt doesn't really involve cash for them, because they are not expecting the money back. It is not unilateralism, it is the fact that the idea of organizing a comprehensive effort is not really on anybody's political agenda yet. That is the problem.

Senator BRADLEY. Mr. Bergsten?

Mr. BERGSTEN. I think there is some unilateralism in it, but I think what is most important is that there is a combination in all of this now, in Western Europe, of unilateralism and regionalism. The new European Bank for Reconstruction and Development is a very sharp slap in the face of the United States.

Senator BRADLEY. Do you mean the Mitterand Bank?

Mr. BERGSTEN. That is right. It is intended to give us a modest role, to give us a smaller share than that of the individual major European countries, not to mention who runs the bank. In part, it is the chickens coming home to roost again, including our being niggardly with the World Bank and the IMF and those resources.

So, there is a regional element to it, as well as a unilateral element, and those redound on the United States and world relationships.

Senator BRADLEY. Let me ask you this: Okay, that has happened. How would you trump it?

Mr. BERGSTEN. I think we need to propose a 100-percent increase in the IMF quota, not 50 percent as our Treasury has now done.

Senator BRADLEY. But how would you trump it to achieve the political gain that you say we might have lost by allowing the French to seize the moment?

Mr. BERGSTEN. We could recoup through the global institutions, which are the ones where we have the most influential role, and that are identified with us on the world political scene. That is the way to trump it.

Senator BRADLEY. Dr. Sachs?

Dr. SACHS. I would say that the first purpose of this bank is to clean up the finances of countries like Poland; let Europe now

reduce 24 billion out of the 27 of Poland's debt in the context of this bank.

Senator BRADLEY. Would you put more U.S. resources into it? Would you reformulate it?

Dr. SACHS. I would reformulate it, to make sure that we are not adding more debt to old debt, and to say that the mission of this thing is to get Eastern Europe on its feet and to make sure that Western Europe does its responsibility in that regard, and recognizes, in part, that in its creditor position it has a special role to play.

I am very concerned about putting new money into Poland without solving the old debt, except for the emergency financing, which is needed.

Senator BRADLEY. Now, this is the last question. This is purely speculative. It is unfair, but——

Dr. SACHS. What the heck.

Senator BRADLEY. A year from now, what will the German mark be? [Laughter.]

Mr. BERGSTEN. Against which currency?

Senator BRADLEY. Against the dollar.

Mr. BERGSTEN. A year from now I think it will be somewhere around 1.50 to the dollar, stronger than it is now, mainly because of a combination of higher growth in Europe, the political change, the higher interest rates coming out of the current environment, plus the renewed growth in our trade deficit, which I expect to see this year. All of that will push the mark up.

What is going to be interesting is the mark-yen rate, because the mark has risen enormously against the yen as the yen has stayed weak against the dollar. I am looking for a catch-up rise of the yen. But you didn't ask about that.

Senator BRADLEY. That is right, but at least it is on the record. [Laughter.]

Let me thank all three of you very much for your willingness to come and talk about the Brady Plan. I think your suggestions have been very helpful. As we try to measure the progress in the next several months, we hope there will be a greater sense of urgency. And also for beginning our focus in the subcommittee on the emerging problems of debt and trade, particularly debt and capital movements, that will flow from integration in Europe and changes in Japanese policy.

While I have you here, let me ask you one more question, and then I have got to go; I have people saying I have to go.

The Japanese surplus. Tell me four places you would like to see the Japanese put their surplus, to help the United States. What, specifically, would you like them to do with their surplus to help the United States? Make it quick, though—dot-dot-dot.

Mr. TUCKER. Buy, buy, buy, and give to the World Bank. Put it right into their own economy.

Senator BRADLEY. Buy what?

Mr. TUCKER. Goods from the world.

Mr. BERGSTEN. One, put it into increased public infrastructure spending in Japan. Two—why are you looking negatively?

Senator BRADLEY. No, no. I am looking for some magic.

Mr. BERGSTEN. That is going to increase their growth and reduce their trade surplus.

Senator BRADLEY. Okay.

Mr. BERGSTEN. That is what we want.

Two, double the amount that they put into the Brady Plan, as part of the augmentation of its resources I talked about.

Three, be big donors to the package Jeff just described for Eastern Europe.

And four, keep buying Treasury bills, because if they don't, we are in big trouble.

Senator BRADLEY. Dr. Sachs?

Dr. SACHS. Well, I would say that the world needs Japan's savings. Some portion of it should be directed toward the things we have talked about. The rest should go to the world's capital markets. And the real answer is that we should stop drawing it here and let the world capital market use the benefit of it.

So, I wouldn't tell them exactly where to spend it, but I would tell them, "Keep saving," because saving is good for the world. We ought to do more of it, ourselves.

Senator BRADLEY. Thank you all very much, and I appreciate you fielding all of the questions.

[Whereupon, at 11:55 a.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted

Prepared Statement of C. Fred Bergsten

Washington, January 29—For the past few years, "Washington"—notably the International Monetary Fund, the World Bank, and the US government—has been urging the Latin American debtor nations to make fundamental changes in their economic policies. A comprehensive, country-by-country analysis of the reform effort to date is presented in *The Progress of Policy Reform in Latin America*, released today by the Institute for International Economics. John Williamson, the author of the study, concludes that the reforms are much more extensive than is generally recognized. This provides a ray of hope for the future from a region where most of the current economic news continues to be grim.

The reform programs in Latin America seek to emulate the macroeconomic prudence, outward orientation, and domestic liberalization that were so successful in the industrial countries during the early postwar era and more recently in the developing nations of East Asia. Latin America is in essence attempting to make the transition from statist authoritarianism to free-market democracy that Spain and Portugal achieved successfully in the last two decades, and that Eastern Europe is now trying to launch.

Results of this new economic realism are still spotty. The best outcomes have been achieved in Chile and Costa Rica: both started the reform process early, both have undertaken very broad-ranging reforms, and both have now experienced four years of solid economic growth. Colombia, with a very effective macroeconomic stabilization program but rather little liberalization, also has a good record. Other countries that have made substantial reform efforts—most notably Mexico but also Bolivia, Jamaica, and Uruguay—have arrested their decline but still not recovered robust growth, although the outlook in Mexico is hopeful if the debt problem is resolved satisfactorily. In contrast, countries like Peru that have moved in the opposite direction have fared disastrously.

The main message of the study to Latin America is that the countries need to sustain, reinforce, and complete the process of policy reform along the lines that are already emerging. Countries like Brazil, Peru, and the Dominican Republic that have not yet embarked on serious policy reform should initiate the process promptly. Those like Mexico, Bolivia, and Jamaica that have succeeded in stabilizing and liberalizing need to ask whether their exchange rate is sufficiently competitive; to seek debt reconstruction within the context of the Brady Plan; and above all to stay the course. If they succeed in the historic task of making the transition to free-market democracies, they will be in a far better position to address adequately the region's appalling problems of poverty and income inequality as well as concerns about environmental degradation.

Because policy reform takes time to produce increased growth, the process needs external help from the industrial countries through its critical early years. Some have called for a new "Marshall Plan," but this suggests an indiscriminate region-wide program, which could actually reduce the incentives to adopt policy reforms. The need is, rather, for a definitive settlement of the debt problem for countries that implement and sustain determined reform programs. Such settlements would offer a visible early benefit of reform to help sustain domestic political support, as well as encourage lagging countries to initiate reform.

The Brady Plan provides for just such a selective approach. The study offers several suggestions for strengthening the Brady Plan: increased levels of financing, more flexible use of IMF and World Bank funds, tax incentives to banks to partici-

pate in debt restructuring, and the extension of debt relief on public export credits. Stabilization loans may also be needed to stop hyperinflation, and lending by the multilateral institutions must be large enough to underwrite continued growth.

The study is based on a conference held at the Institute for International Economics in November 1989. Papers on eight Latin American countries (Argentina, Bolivia, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela) and two groups of small countries (in the Caribbean and Central America) assessed the progress made in each country in each of ten areas:

—the restoration of fiscal discipline
—reordering of public expenditure priorities away from indiscriminate subsidies, defense, and administration and toward education, health, and infrastructure
—tax reform, to broaden the tax base and cut marginal tax rates
—financial liberalization
—establishment and maintenance of a competitive exchange rate
—trade liberalization
—removal of obstacles to foreign direct investment
—privatization
—deregulation
—the establishment of secure property rights.

In synthesizing the findings of the country papers, Williamson examines the extent to which a consensus seems to exist on the desirability of each of the 10 objectives. He concludes that there is very wide support for reforms needed to underwrite macroeconomic stabilization and open the economy, namely, fiscal discipline, a competitive exchange rate, and trade liberalization. However, those bearing on redefinition of the development model—like the reordering of public expenditure priorities, financial liberalization, privatization, deregulation, and property rights—remain more controversial.

A series of nine tables provides details of the policy steps that have been taken by the 10 major debtor countries of the region (the eight countries listed above plus Jamaica and Costa Rica). Table 10 (attached) summarizes those tables, giving an overview of which countries have acted in which areas. Table II (also attached) relates policy reform to subsequent economic performance in terms of restored growth.

The proceedings of the conference that provided the background for the study will be published by the Institute in March. A table of contents of the volume is appended.

ABOUT THE AUTHOR

John Williamson, a Senior Fellow at the Institute for International Economics since 1981, was professor of economics at Pontificia Universidade Catolica do Rio de Janeiro (1978–81), the University of Warwick (1970–77), the Massachusetts Institute of Technology (1980, 1967), the University of York (1963–68), and Princeton University (1962–63); Advisor to the International Monetary Fund (1972–74); and Economic Consultant to the UK Treasury (1968–70). He is the author of numerous studies on international monetary and Third World debt issues, including *Voluntary Approaches to Debt Relief* (1988), *Targets and Indicators: A Blueprint for the International Coordination of Economic Policy* (1987), *Capital Flight and Third World Debt (1987)*, and *The Exchange Rate System* (1985).

ABOUT THE INSTITUTE

The Institute for International Economics is a private, nonpartisan, nonprofit research institution for the study and discussion of international economic policy, directed by C. Fred Bergsten. It was created in 1981 to provide fresh analyses of major issues in this area and practical new approaches for dealing with them. The Institute receives its funding from a large number of private foundations and corporations. About 10 percent of the Institute's resources in the latest fiscal year came from outside the United States, including about 3 percent from Japan.

TABLE 10 Latin America: summary of policy reform in the 1980s

Country	Fiscal discipline	Public spending priorities	Tax reform	Financial liberal-ization	Competitive exchange rate	Trade liberal-ization	Foreign direct investment	Priva-tization	Deregu-lation
Bolivia	++	++	++	++	+	++	+	0	++
Chile	+	0	+	++	++	++	+	++[a]	+
Peru	−	−	0	−	−	−	−	−	0
Argentina	+	0	0[a]	0	+	0[a]	+	+[a]	+[a]
Brazil	0	−	+	0	+	0	−	+	−
Mexico	++	0	++	0	+	++	++	++	+
Colombia	++	0	+	+	++	+	0[a]	+	0
Venezuela	0	0	0[a]	+	+	++	+	+[a]	+
Jamaica	+	0	++	+	+	++	+	+	+
Costa Rica	++	0	++	0	++	+	+	+	+

++ substantial reform
+ some reform (or no need to reform)
0 no significant change (or mixed changes)
− retrogression
a. More action expected shortly.
Sources: Country papers in Williamson (1990) and personal communications with authors.

TABLE 11 Latin America: policy reform and economic performance

Policy reform	Growth	Stagnation	Decline
Yes	Chile (1974–84) Costa Rica (1983–87)	Bolivia (1985) Mexico (1983–88) Jamaica (1985–86) Uruguay (1974–86)	Trinidad and Tobago (1987)
Partial	Colombia (1983–84)[a] Barbados	Guatemala (1986)[a]	
No		Brazil Dominican Republic Honduras	Peru Nicaragua
Recent	Paraguay	Venezuela El Salvador Ecuador	Argentina Guyana

Note: Years in parentheses denote period of principal reforms.
a. Major reforms in macroeconomic policy only.
Source: See table 10 and text for rows, table 12 and text for column classification.

Contents

Preface *C. Fred Bergsten*

1 Introduction *John Williamson*

2 What Washington Means by Policy Reform *John Williamson*
Comments *Richard Feinberg*
Stanley Fischer
Allan H. Meltzer
Patricio Meller
Discussion

3 Three Policy Experiments
Bolivia *Juan Cariaga*
Chile *Patricio Meller*
Peru *Pedro-Pablo Kuczynski*
Comments *Vittorio Corbo*
Barbara Stallings
Richard Webb
Discussion

4 The Three Major Debtors
Brazil *Eliana Cardoso and Daniel Dantas*
Mexico *Javier Beristain and Ignacio Trigueros*
Argentina *Juan Carlos de Pablo*
Comments *William R. Cline*
Sebastian Edwards
Sweder van Wijnbergen
Discussion

5 Colombia and Venezuela
Colombia *Rudolf Hommes*
Venezuela *Ricardo Hausmann*
Comments *Sterie T. Beza*
Felipe Larraín

6 The Smaller Countries
The Caribbean *DeLisle Worrell*
Central America *Sylvia Saborío*
Comment *Susan Collins*
Discussion

7 Panel Discussion: Latin American Adjustment: The Record and Next Steps
Rodrigo Botero
Rudiger Dornbusch
Arnold Harberger
Victor Urquidi
Discussion

8 From Policy Consensus to Renewed Economic Growth
Enrique Iglesias

9 The Progress of Policy Reform in Latin America
John Williamson

Appendices

PREPARED STATEMENT OF SENATOR BILL BRADLEY

The purpose of this hearing is to explore the relationship between debt, development, democracy and drugs; to review the implementation of the Brady Plan for debt relief in its first year; to suggest possible modifications to the current debt relief approach; and to study the applicability of the debt relief concept to Eastern Europe.

Almost exactly a year ago, the administration recognized that debt reduction can alleviate the debt burden that has been driving many developing countries into deep poverty. I welcomed this decision, because Secretary Brady's speech marked a major turn away from his predecessor's belief that the answer to too much debt was more debt. But I felt it appropriate to wait to see how the new Brady Plan would be implemented before offering more detailed opinions on the plan.

A considerable amount of effort has gone into implementing the plan over the past year. In may, the international financial institutions and Japan agreed to provide $30–35 billion to support debt relief operations on a case by case basis. The first beneficiary of the plan, Mexico, signed its debt relief agreement on February 4 of this year. Costa Rica has nearly wrapped up a program to buy-back virtually all of its commercial bank debt at about 16 cents on the dollar. The Philippines is working on a program of new money, and Venezuela is undertaking significant reforms with an eye to entering negotiations with the banks soon.

But even if the Mexican deal is considered adequate—and some doubt this, there is considerable question as to whether the plan, as currently constructed, can readily be applied beyond those countries I have mentioned to the fifteen other severely indebted middle income countries. The banks, most of which have established significant reserves against their LDC debt, seem extremely reluctant to enter into new negotiations. Major debtors, especially Brazil and Argentina, are using arrears to obtain debt relief and are questioning whether the Brady Plan can offer them anything better. The international financial institutions and the creditor governments appear to recognize that we've hit an impasse, but have yet to suggest useful ideas to break the log jam.

I am deeply concerned that debt fatigue has now overcome the negotiators, and that we are in for a prolonged period of "muddling through." If so, this course can only lead to disaster. The severely indebted middle income countries simply cannot sustain net resource transfers to the developed world of the magnitude they suffered last year—some $50 billion. They cannot afford to see further major declines in real incomes. They cannot afford the hyperinflation that servicing their foreign debt so often leads to. They cannot afford to have scarce government resources taken away from education and health, to see increases in infant mortality rates. We cannot afford it either this impoverishment offends our humanity, can endanger our national security, and directly affects our economic interests through reduced exports.

It is therefore essential that we ensure that the burden on these countries is reduced—responsibly—to a point where the countries can return to growth.

I want to emphasize that I believe strongly that the greatest single impetus to growth in the developing world will come through access to the import markets of the developing countries, not only the United States, but also Western Europe and Japan. There is perhaps no more important instrument for growth than a liberal trade regime, enforced through the multilateral regime of the general agreement on tariffs and trade. The success of the current Uruguay Round of negotiations is essential. The developing countries have a deep stake this, and they must also be willing to assume the responsibility of maintaining and enhancing the GATT regime.

But trade too is insufficient; some relief from the net outflow of resources from these countries is essential. The World Bank believes that the burden of servicing the debt overhang in developing countries has fallen most heavily on investment, reducing the long term growth potential of these countries. The potential growth lost from the seventy billion dollars that have flown from the Baker 17 to their creditors cannot be restored, but future drains of such magnitude can—and should—be prevented.

Currently, the Brady Plan is the only instrument to provide this relief. The question is—is the plan, in its current form, sufficient to this purpose? Does it ensure that the necessary resources remain in the country? If not, what are the implications for development, for drugs, and for democracy in the heavily indebted countries? Can, or should, the plan be modified? How? Is it enough to address the burden of commercial bank debt, or should creditor governments consider forgiving official debt, as they have recently decided to do for the low income countries of sub-Saharan Africa.

This question of official debt reduction is particularly germane to the Eastern European countries included in the World Bank's list of the severely indebted middle income countries, namely Poland and Hungary. Poland, in particular, labors under one of the highest debt service burdens in the world, and 70 percent of its debt is from official sources. Hungary, on the other hand, whose per capita debt burden exceeds that of Poland, owes most of its money to commercial banks. In both cases, as elsewhere in Eastern Europe, the people have brought about a most courageous change, throwing off a bankrupt system that had been imposed on them. The West needs to be able to support them, to ensure that their experiment with democracy and met reforms succeeds. Aid alone may not be enough; we should consider also the extent to which debt reduction can fuel these countries' growth.

I am therefore pleased to have today Messrs. Tucker, Sachs and Bersten here today to share with the committee their thoughts on these issues. I suggest that Mr. Tucker open the discussion, focusing on the impact of the debt crisis on LDC development, followed by Mr. Sachs and Bergsten to discuss in more detail the implementation and possible modifications of the Brady Plan, and its applicability to Eastern Europe.

PREPARED STATEMENT OF STUART K. TUCKER

Mr. Chairman and members of the subcommittee, thank you for inviting me here to speak on impact of the debt overhang. The following views are my own and do not necessarily reflect the opinions of my colleagues at the Overseas Development Council or its Board of Directors.

When speaking of Third World development in the 1990s, clearly there is one issue which overrides all others: the debt crisis. However, citizens in the United States do not seem to see the issue as affecting their self-interest in the same way that the developing countries view it.

First, I will review the *U.S. self-interest* in resolution of the debt problem. Then, I will point to the impact that the 1980s debt crisis will have on development in the 1990s, which constitutes a substantial *humanitarian reason* for action to resolve the debt problem.

I. THE DEBT CRISIS AND THE UNITED STATES

In 1986, arguably one of the worst points in the debt crisis, a poll of American public opinion revealed that only 7 per cent of Americans thought that debt relief should be among the top priorities for U.S. efforts to help the poor countries in the world. Debt relief ranked behind a dozen other policies including military bases and promotion of U.S. investment abroad. Furthermore, 80 per cent of those polled said that the United States should help its own economy before helping reduce the debt burden in the Third World. The poll found only slight evidence that Americans understood the nature of U.S. economic interdependence with the Third World.[1] More often than not, Americans view the domestic economy as being quite separate from the international economy. Yet, the terms "domestic" and "international" are no longer meaningful terms.

You would think that the oil crises of the 1970s would have taught well the lesson of interdependence. Yet, industrial-country governments have been slow to react to the implications of the current Third World debt crisis. The slow reaction of public opinion and U.S. policymakers alike is due to a dim understanding of the relevance of the debt crisis to U.S. prosperity.

The oil crises of the 1970s, mounting debt burdens, and global recession in the 1980s have precipitated a debt crisis and a dramatic drop of developing-country incomes.[2] Though on the surface it appears that the United States has largely recovered from the recession, we are facing a series of economic difficulties fostered by the debt crisis.

U.S. prosperity has been diminished, because of our poorly performing financial and trade relations with the troubled Third World. These debtor countries have dramatically cut the size of their imports from us, and increased their exports to us, in order to earn enough currency to service their debt. The continuing crisis is a major cause of the large U.S. trade deficits and our own rapidly growing status as a debtor nation.[3] U.S. exports to developing countries are now about $60 billion less than they could have been in the absence of debt and recession in developing countries in the 1980s. Over the course of the 1980–87, we lost over $330 billion of export sales.[4] More to the point, due to these lost exports, we lost 1.8 million jobs—well over one-fifth of our current level of unemployment. And to use a politicians words, these were "good" jobs.[5]

U.S. investments in developing countries have suffered as well. Profit rates for U.S. direct investment in the Third World were cut in half during the early 1980s.[6] And of course, the very stability of the world's financial system has been shaken repeatedly by the debt crisis. Once, these very same debtor countries were the most vibrantly growing markets for our goods and services. Now, cities and farms across the United States are suffering income losses and unemployment, instead.

II. DEBT AND PROSPECTS FOR DEVELOPMENT IN THE 1990S

In the Third World, knowledge of the impact of the debt crisis on living standards is widespread, indeed unavoidable.

Curtailed Income. Whereas the per capita income of highly-indebted countries grew by 4.0 per cent annually during 1965–80, their income fell by 1.4 per cent per year on average through 1988. The per capita income of the 17 highly-indebted countries in 1988 was 10 lower than in 1980. Sub-Saharan Africa's income fell by 19 per cent over the same period. Debtor-country income is now one-third less than what it would have been in the absence of recession and debt. These countries have lost over a decade of time in their struggle to develop. Over the course of 1980–88, the 17 highly-indebted countries lost over $2 trillion (in constant 1986 values) in foregone income—nearly four times the amount of their payments to creditors.[7]

Furthermore, the prospects for making up the lost time are bleak as well. In the early 1990s, per capita income of debtor countries is expected to grow about 1.5 or 2.0 per cent annually, far below the 4.0 per cent sustained throughout the 1950s, 1960s and 1970s. Even if income per capita grew at 4.5 per cent per year (0.5 per cent faster than in the "golden years"), the income of the highly-indebted countries would not catch up to the extension of that 1965–80 trend line (4 per cent growth from 1980 onward) until the year 2077. This dampens development hopes for the lifespan of the generation born in the 1980s.

Reduced Consumption. With the collapse of income, many debtor countries cut savings and sacrificed investment in the 1980s in order to meet consumption demand. However, consumption in the 1990s will be significantly constrained by the impaired income growth that will result from the low investment.

Public Sector Capacity Reduced. The recession and debt crisis of the early 1980s led to dramatic retrenchment of public spending priorities. Interest payments of public sector debt rose from 9 per cent of Latin American government spending in 1980 to 27 per cent in 1986. The orthodox policy prescriptions of the IMF kept Latin American governments from boosting government spending as a portion of GDP during the debt crisis. Consequently, other programs had to be cut to cover the interest burden. Unfortunately, the short, sharp pain inflicted by this policy has turned out to be not so short-lived.

Greatly complicating the problem, Latin American governments are still hampered by capital flight and an inability to tax equitably or progressively.

Social Programs Pared Back. During the early 1980s, Latin American governments have responded to this reduced public sector capacity by cutting back social spending on health, education, social security, welfare, housing, and community amenities. Between 1980 and 1985, social spending in these areas was cut from 44 per cent of the government budget to 36 per cent. Although Latin American governments certainly were plagued by inefficiencies in the public sector, the major impact of the social spending cuts has been a cut in investment in schools, books, health clinics, and housing. In general, operating expenses instead of investment received what funding existed. Therefore, the infrastructure of social programs has eroded and will demand larger attention in the 1990s, even though the funding is not going to increase. Thus, Latin America has a growing social debt" which will reduce its development potential in the 1990s and thereby increase the future costs of development.

Trade Imperatives. The debt crisis has forced debtor countries to maintain structural merchandise trade surpluses in order to have the foreign exchange surpluses necessary to service the debt overhang. Import compression is still the order of the day. The import shortages in the 1980s have cut into capital expenditure, which in turn will curtail future growth. The global trade imbalances caused by the debt have spawned a number of North-South trade conflicts, especially over labor-intensive manufacturing trade, where resides the most Third World employment potential.

Also worrisome is the advance of technological change with little technology transfer. Many countries in the Third World in the 1980s have either faced huge debt problems or long-term declines in their commodity prices and therefore have not been able to afford to develop technological capacity. The continuing economic stagnation gives little hope of attracting large scale foreign investment in technolo-

gy-intensive industries. The absence of technological advance in developing countries will only make trading more difficult in future decades.

Environmental Degradation. Diminishing agricultural trading opportunity and the long-term economic slowdown caused by the debt crisis have pushed along the urbanization process in developing countries. Some of the world's worst environmental problems are being created in Third World urban cauldrons. Diminished governmental capacity means few services reach the urban slums.

The export imperative has pushed many debtor countries into cash export crops that are not easily grown in their climates. Furthermore, high trade and health standard barriers exist in the buying countries. Thus, the use and abuse of pesticides in debtor countries has remarkably risen in attempt to increase productivity of agricultural goods acceptable to industrial-country markets.

The lack of cash to purchase energy has led many populations with access to forest products to cutting down the trees and burning them for energy. These poor populations are making the choice of sacrificing the future of the land in order to survive in the present—and who can blame them? Few would choose otherwise.

In short, soil erosion, chemical contamination, deforestation, overcropping, and other biosphere disruptions are natural outgrowths of the stagnant economic conditions in debt countries.

Political Instability. On the one hand, many Latin American military governments have been discredited by their handling of their economies during the 1980s. On the other hand, now the mantle of leadership is on the shoulders of democrats, who have no more tools, and perhaps less maneuvering room, than their predecessors to handle these problems. We have begun to see a wave of populists running on anti-repayment platforms—and they are not only populist, they are popular. Political durability is not likely to be a feature of any Latin American leader in the 1990s.

Population Pressures Worsening. The rural poor have been known to opt for more children when their incomes are most at risk, because the children can be used as unpaid laborers (this is also a characteristic of some urban poor populations as well). Thus, in subsaharan Africa, where income has fallen the most, population growth rates have actually increased, despite international efforts to institute family planning. During 1965–80, subsaharan African population grew at a rate of 2.7 percent per year. During the early 1980s, it grew 3.1 per cent annually. In the 1990s, it is expected to grow 3.2 per cent per year. The need for income growth, therefore, will grow, not decrease in the 1990s.

Narcotics Production. In a climate of economic stagnation or retreat, socially unacceptable behavior becomes an option whose benefits outweigh the risks. As demand for narcotics has increased in consuming countries, and as international interdiction efforts on trade and production increase, the price differential between legal and illegal crop production has widened. This is being matched in developing countries by an economically rational supply response. When legitimate economic activity in the debt era is so unprofitable and people are being pushed to the margin of existence, it is no wonder that Third World farmers are turning to the illegal, but highly profitable, activity of narcotics production to make a living. Yet, the bulk of U.S. international anti-narcotics policy is aimed at punishing the producers. The tools used by U.S. policy (trade barriers and production suppression) have the very recognizable economic effect of dramatically increasing narcotics prices and causing a surge of new entrants into illegal production.

Long-term Standards of Living. Not all development initiatives have come to a halt during this period, infant mortality, child mortality, literacy, and life expectancy figures have continued to improve in most developing countries. However, continuation of progress depends on the slow effects of long-run investments in health and education. We have already begun to see a slight slowdown in the rate of progress in these physical standards of living.

III. CONCLUSION

Absolute poverty is a major problem to be addressed in the 1990s, and it has large effects on the welfare of the U.S. economy. Managing the international system through its financial and trade traumas may be more difficult in the period ahead. The environment will loom ever larger over all our economic choices. Social ills (such as narcotics trade) become pronounced during such long periods of economic stagnation.

Even if the financial side of the debt crisis were to be resolved by the Brady Plan, the world would have to live with its effects for some time to come. This is the human tragedy within which all development policies in the 1990s must operate.

For U.S. business, many profitable opportunities have gone down the drain or will never exist, because of this tragedy. Yet, even without this direct U.S. self-interest, the United States has substantial humanitarian reasons for action on the debt crisis.

ENDNOTES

1. *What Americans Think: Views on Development and U.S.-Third World Relations,* A Public Opinion Project of Interaction and the Overseas Development Council, Report prepared by Christine E. Contee (1987).
2. See *Adjustment Crisis in the Third World,* edited by Richard E. Feinberg (U.S.-Third World Policy Perspectives, No. 1, New Brunswick, NJ: Transactions Books, 1984) for analyses of the origin of and problems created by the debt crisis.
3. Stuart K. Tucker, "U.S.-Third World Trade Deficit: Going After the Causes," ODC *Policy Focus* 1985, No. 7 (November 1985).
4. For more analysis of U.S. interdependence with developing countries, see *Growth, Exports, & Jobs in a Changing World Economy: Agenda 1988* edited by John W. Sewell and Stuart K. Tucker (U.S.-Third World Policy Perspectives No. 9, New Brunswick, NJ: Transaction Books in cooperation with the Overseas Development Council, 1988).
5. "The Debt-Trade Linkage in U.S.-Latin American Trade," statement of Stuart K. Tucker before the Subcommittee on International Economic Policy and Trade of the House Committee on Foreign Affairs, U.S. Congress, September 29, 1988.
6. Stuart K. Tucker, "Update: Costs to the United States of the Recession in Developing Countries," (ODC Working Paper No. 10, January 1986).
7. See Stuart K. Tucker, "The Legacy of Debt: A Lost Decade of Development," *ODC Policy Focus,* 1989, No. 3 (Overseas Development Council, June 1989).

COMMUNICATIONS

The Mexican Debt Accord: Lessons for the Brady Plan

Statement of

Shafiqul Islam

Senior Fellow
Council on Foreign Relations

I. The Mexican Debt Accord: Simple Arithmetic and Complex Questions

Mexico began negotiating with the banks in April 1989. The Mexican authorities estimated that it needed to meet an annual financing gap of $7 billion through the mid-1990s. With the support of the IMF and the World Bank, they proposed to meet this gap by reducing their interest bill to the banks by $2.5 billion (with a 50 percent discount on their $50 billion medium- and long-term public-sector loans), borrowing new money of $2 billion or so a year for six years, and offsetting the remaining gap by rescheduling the principal.

Last Sunday, President Carlos Salinas de Gortari threw a party in Mexico City to celebrate a debt agreement that offers net annual interest relief of about $1 billion, new bank loans of $0.5 billion a year on average for the next three years, and 30-year principal rescheduling of most of the old longer-term bank loans of Mexico's public sector. So Mexico is getting interest relief, fresh money and principal rescheduling. The only problem is it is getting 40 percent of the interest relief and 20 percent of the new money that only nine months ago the IMF and the World Bank thought Mexico needed to eliminate its debt overhang and put the economy on a path to sustainable economic recovery.

The agreement offers Mexico an "effective relief" of about 14 percent on its $95 billion external debt: the reduction in principal and interest lowers the present value of Mexico's total debt by $14.5 billion; but Mexico is using up $1.3 billion of its own reserves to back the new bonds (the $5.8 billion additional borrowing for collaterizing the bonds are almost fully offset by an equal increase in Mexican foreign assets); so the effective debt (principal and interest) reduction is about $13 billion -- 14 percent of its total debt. The "effective risk-adjusted discount" banks are offering is not 35 percent as we are often told, but happens to be a bit more than 10 percent. They are giving up $14.5 billion in exchange for "credit enhancement" of $7 billion for the restructured claims. So the "effective risk-adjusted debt reduction" is in fact $7.5 billion -- 10.7 percent of their $70 billion claims on Mexico.

The agreement also relieves Mexico of the obligation to repay about $7 billion of principal in the year 2019. The collateralization of the principal "defeases" another $35 billion. Mexico is in effect paying now $35 billion of principal due in 2019. And the banks are permitted to engage in debt/equity conversions ($1 billion per year over the next three and a half years) -- a demand that the Mexican negotiators refused to even discuss when the negotiation began last May.

Since the signing of "the agreement in principle" in July 1989 Mexico has hailed the accord as a major breakthrough and resolutely defended its creditor banks against those who critized them for offering much less relief than what Mexico needed and wanted. What explains this role reversal by Mexico? Why has the same Mexico that vehemently criticized its creditor banks for "keeping their eyes closed to economic reality" before the July agreement, suddenly turned around and become their leading defender even though it received about one-third of the relief it claimed it needed?

US Treasury Secretary Nicholas Brady also applauded the agreement as "a major accomplishment," and ascribed part of the credit to the Brady plan. He observed, "Mexico is on the move again. Jobs are being created. Flight capital is returning.

Investor confidence is growing... In short, a new dawn is rising." How important a role has the Brady initiative played in Mexico's improved economic performance? Is it really true that the burden of foreign debt has been "removed from the shoulders of the Mexican people?"[1]

These are the questions I address here. I also try to look for lessons in the Mexican experience that may have relevance for the principle and the practice of the Brady plan. My remarks focus on three areas: (1) the implications of the debt accord for the Mexican economy; (2) what the Brady plan can learn from the Mexican experience; and (3) my own thoughts on how the lessons from Mexico can be used to strengthen the debt strategy.

II. The Debt Accord: Implications for Mexico

The accord will benefit Mexico in two other ways. First, Mexico no longer has to worry about repaying 85 percent of the principal of its remaining longer term public-sector loans. Second, almost half of these loans will be protected from interest-rate volatility -- the vicissitudes of the monetary-fiscal policy mix in Washington and mood swings of the market on Wall Street will be partially prevented from causing uncertainty in Mexico City. The accord's effect on Mexico's interest bill is less encouraging. Last year, Mexico appears to have paid to its foreign creditors over $9 billion in interest, and in the process used up more than 25 percent of its earnings from exports of goods and services. The relief resulting from the decline in interest rates over the past year is likely to be equal to $1 billion interest relief offered by the debt accord. And the benefit from the rising oil prices over the same period (despite declining oil export volume) will likely approach three times the Brady interest relief. Thus with markets more generous than the debt accord, Mexico's interest bill this year is likely to be around $8.0 billion and the interest/export ratio may

---

1 "Debt-Cutting Pact Signed in Mexico," The Washington Post, February 5, 1990, p. A1, A16.

drop to as low as 20 percent. But even then Mexico will still remain a "severely indebted middle-income country" (SIMIC) in terms of the World Bank's interest/export ratio criterion.

One thus cannot help feel somewhat bewildered that President Salinas and the international financial community are celebrating a debt accord that will do no more than help move Mexico from being "a severely indebted country" to a less "severely indebted country." It seems that Angel Gurria, Mexico's finance undersecretary was greatly exaggerating the news of the death of debt when he declared on Sunday that, "We are beginning the period of life after debt."[2] It is also difficult to understand why Mexico's 1987-88 average interest bill of $8.5 billion was seen as stifling investment and growth, while interest payments of $8 billion in 1990 are being viewed as no threat to sustained economic recovery. It is hard to believe that a sum of half a-billion dollars has the power to make or break Mexico.

The key to demystifying these apparent puzzles is to recognize that the linkage between the macroeconomic burden of servicing the debt and economic growth is much more complex than what politicians make it out to be: while tinkering with the interest bill alone is unlikely to exert measurable influence on this linkage, modest debt relief in the context of sound economic policies, credible political leadership, various internal (earthquake) and external (oil price) shocks, and sheer luck can have a much more profound impact on the interrelationship between debt and growth. This view -- and not a mechanical relationship between interest payments and economic growth -- is consistent with the fact that the year (1984) Mexico paid the largest interest bill ($11.3 billion) was also the year when it experienced the highest per capita income growth (1.4 percent). By contrast, per capita income dropped a whopping 6 percent in 1986 as Mexico's interest bill shrank to $8.4 billion.

So while the direct financial benefits from the debt accord are rather modest; with sound economic policies in place, a credible national leadership can extract much indirect psychological and political gains from the very fact that a debt agreement has been reached. That is precisely what President Salinas and his cabinet

---

[2] Ibid.

are doing, and they are doing it skillfully and successfully. Bluntly put, having failed to achieve what the Mexican authorities needed to eliminate the debt overhang, they are putting their mouth where there is no money.

This strategy seems to be working partly because God and markets have recently been unusually kind to Mexico. Last year, per capita income grew almost one percent after stagnating and declining for four years in a row. A sharp rise in oil prices gave President Salinas a lucky break. The extraordinarily high real interest rates brought some flight capital home, and the combined package of deregulation, special incentives and aggressive campaigns to attract investors brought in foreign investment, although not at any greater scale than in 1988. Mexico managed to run a small trade deficit and experienced a net <u>inward</u> transfer of resources for the first time since 1981, resulting in an increase in foreign exchange reserves. And all this was accomplished without any new money from the banks. Despite high real interest rates, Mexico also saw a continuation of the investment boom that began in 1988, and industrial production rose about 6 percent last year.

Finally, CPI inflation fell further: 1989 began with inflation of 35 percent and ended with a 20 percent rate. The Pact for Economic Solidarity (PECE) -- a social contract between labor, business and government -- has played a critical role in the authorities' success in gradually bringing inflation down from the peak of nearly 180 percent reached in early 1988 and its daily-devaluation policy has kept the peso from becoming increasingly overvalued.

Thus Mexico's good economic performance reflects the combined effect of improved policies, a kinder market and a gentler nature, and not so much the impact of the Brady plan. The US Treasury, the Mexican authorities, the banks and some analysts have given much of the credit for several positive developments to the July 1989 announcement of the debt accord, but the facts show otherwise. For example, the data do not support the concerted claim that the July announcement led to a confidence driven capital repatriation to Mexico: out of the estimated $2.5 to 3 billion net return of flight capital, extremely high real interest rates brought back $2 billion

of speculative and short-term money before the July announcement; thereafter, the rate of reflow in fact slowed down as declining real interest rates apparently more than offset positive confidence effects.

The claim that a sharp rise in confidence from the July announcement led to over 20 percentage points decline in real interest rates saving the government $8 to $12 billion in interest payments on its massive and growing internal debt is exaggerated and misleading.[3] To begin with, the invisible hand of confidence was not the only factor driving the Treasury bill rate down, the visible hand of the Mexican central bank also played a role through intervention in the bill market. Second, if the debt accord be given the credit for lowering real interest rates through boosting confidence, then economic logic requires that the delay in announcing a debt reduction plan until March 1989, and the failure to reach an accord until July be blamed for rising rates since the end of 1988. Thus one can argue that while the debt accord may have offset 20 percentage points of the 40 odd point rise in real interest rates, a larger relief package would have led to greater declines in the rate, and the fact that real interest rates still remain extra-ordinary should be ascribed at least partly to the remaining debt overhang.

Finally, a similar reasoning should lead one to conclude that if the debt accord is now saving the Mexican government $8 to $10 billion in interest on its internal debt, then a great part of the internal debt, and of interest payments that the Mexican government is making on this debt should also be ascribed to the failure to adopt a strategy of debt reduction and to reach a debt reduction agreement a few years earlier.

Mexico expects to grow about 4 percent this year, and the debt accord should help, especially as a confidence-booster to add to the momentum of economic recovery. But with an interest bill of $8 billion (nearly 4 percent of GNP) to service, the behavior of non-bank capital flows uncertain, and economic recovery still

3 William R. Rhodes, remarks at the [illegible] and Business Cooperation between Latin America and Japan, Nagoya, Japan, November 13, 1989.

fragile, the economy remains highly vulnerable. The debt accord has given Mexico little cushion for absorbing any adverse internal (e.g. another earthquake) or external (e.g. a decline in oil price or a US recession) shock, and any major policy error. With little room for mishaps or mistakes, President Salinas will have to walk a tight rope. If all goes well this year, the economic recovery may take hold and begin a virtuous cycle of investment, growth and confidence.

With per capita income still at the level of the late 1970s, and economic and social infrastructure in shambles, Mexico has a lot of catching up to do over the medium term. President Salinas and his colleagues seem determined to put Mexico back on the path of sustained growth and development; it is disappointing that the Brady plan missed the opportunity to make their task a bit easier.

III. Lessons for the Brady Plan

Mexico's experience with debt restructuring offers a number of lessons for restructuring the Brady plan itself. I will highlight a few of them in the context of addressing several myths that have plagued the Brady plan from day one, and show no signs of going away.

Myth 1: The Brady plan's emphasis on debt reduction will discourage banks from providing new loans to the debtor countries, thus depriving them of much-needed resources for financing their growth and development.

This argument is wrong on two counts. First, a major force behind replacing the Baker plan (which encouraged the banks to provide fresh loans) with the Brady plan was precisely the fact the banks had already stopped providing new loans to the debtors. It is the failure of "forced lending," that forced Washington to reluctantly embrace "voluntary debt reduction," not the other way around. In 1986, nothing short of a threat of default from Mexico and persistent arm-twisting was required to get the banks to go back to the table for negotiating a new money package for "the model debtor" when Mexico's debt was selling in the secondary market at 55 cents on the dollar. It would have been almost impossible to pursuade the banks to cough up more money in 1989 when they themselves were coming up with ideas for debt reduction (e.g. the Mexico-Morgan scheme), and the secondary market price of Mexican loans was heading south after having already dropped below 40 cents on the dollar by January.

Second, during the 1970s, commercial banks were not providing resources to today's debtor countries for meeting their needs of sustainable development; they were financing the countries' unsustainable budget and balance-of-payments deficits. Too much new money from the money-making banks to the adjustment-averse countries is what largely caused the debt problem in the first place. After the nervous banks precipitated the crisis by suddenly pulling out, they stopped financing the twin deficits of the debtors. Then the tables turned, and it was the debtors that began to provide resources to the banks for supporting their profits. For example, with all the "new money" from the banks, Mexico alone transferred to them a net sum of over $40 billion during 1982-89 as debt service for its long-term loans.

Thus it is sheer nonsense to lament that "no new money" from the banks is going to hurt the development prospects for the countries. The little new money that banks involuntarily provided to the big debtors since 1982 came right back to them as it helped ensure an uninterrupted flow of money from the debtors. Indeed, the economic logic (but not necessarily Washington's policy motivation) behind debt reduction has always been to stop this "Ponzi scheme" of new money refinancing interest payments, and to partially disengage the banks from depriving the debtors from much-needed resources to finance growth and development. The worrisome aspect of the Mexican agreement is thus not that Mexico got little new money from the banks; rather, it is that Mexico succeeded only modestly in preventing the banks from siphoning off its home-grown savings over the next three decades for the money it borrowed over one decade, much of which had already been wasted or had returned to the same banks as deposits.

Another myth that seems to be widely shared by the bankers, the debtors and the international official community alike concerns the linkage between the size of available official resources and the extent of debt reduction.

Myth 2: There are simply not enough official resources to support significant debt reduction.

One recent articulation of this myth comes from the World Bank, "The announcement of the new strategy led to high expectations...

Amounts of debt and debt service reduction attainable under the new strategy, however, might fall short of these expectations, especially since funds to support debt reduction are limited. ...$30 billion to $35 billion in official resources could lead to an average reduction in annual contractual debt service over the period 1990-93 of approximately $6 billion."[4]

This line of reasoning starts from a flawed premise, and thus gets the arithmetic wrong. Common sense says that the deeper the discount, the smaller the amount of the remaining debt, and thus the lower is the need for official resources for collaterizing it. That is, a smaller amount of official resources can support a deeper debt reduction. By the same token, shallow discounts will require large amounts of collateral to bring a large stock of debt under a debt reduction program. By now it should be clear what the real source of concern is not the lack of taxpayers' money to support adequate debt reduction (to collaterize debts with deep discounts); the concern is over the lack of money to support inadequate debt reduction (to collateralize debts with shallow discounts).

This implicit rejection of the option of adequate debt reduction (deep discount) compounds the need for official resources in another way. As the IMF, the World Bank and the major creditor governments refuse to be guided by the principle of adequate debt reduction, they remain unsure that the restructured debts will be fully serviceable, and hence make the prudential assumption that there is a high probability that the country will default even on its reduced stock of bank debts. This in turn leads to the insistence that the principal of the restructured debts as well as interest payments over a one to two year period will have to be fully collateralized.

It seems odd that the same officials that insisted before the announcement of the Brady plan that the middle-income debtors with poor policies can fully service their debts and thus need no debt relief, now in effect assume with equal conviction that countries pursuing sound policies and debt reduction will likely fail to fully service their remaining debts. Thus they put up the taxpayer's

---

4 The World Bank, World Debt Tables, 1989-90: External Debt of Developing Countries, Vol. 1, 1989, p. 25.

money to support debt reduction that they publicly claim as adequate; but at the same time, the principle they follow to collaterize the restructured debts imply that they do not really believe the debt reduction is adequate. This schizophrenia results from the unspoken dismissal of the notion of deep discount which in turn reflects the absense of economics in determining what constitutes "adequate debt reduction."

The Mexican experience vividly illustrates these conundrums and contradictions. To see that, imagine for a moment an alternative strategy resulting in a somewhat different debt accord. To begin with, the IMF and the World Bank staff -- in consultation with the debtor country -- prepares an estimate of adequate debt reduction. Debt reduction is considered adequate if it is sufficient enough to meet at least three conditions simultaneously: recovery of growth and investment to "high-employment" and sustainable levels; the full serviceability of the restructured debts; and complete elimination of the need for new money from the commercial banks for the sole purpose of making interest payments.

As part of the exercise of estimating the "financing gap," the staff of both institutions can come up with an estimate of "debt servicing capacity gap," from which they can derive an estimate of "adequate debt reduction." Needless to say, calculations of this nature will be highly sensitive to various assumptions as most such estimates are, and can only be approximate. But even then they will provide the most effective basis for negotiations between the debtor nations and the banks.

Now suppose the estimate for adequate debt reduction for Mexico turns out to be annual interest relief of about $3 billion, implying a 65 percent discount on Mexico's long-term public-sector debts to the banks. This level of discount is not as outrageous as it seems: it can bring Mexico's interest/exports ratio down to 15 percent -- a criterion that transforms Mexico from a severely indebted country to a moderately indebted country in terms of the World Bank definition. And it is consistent with the market-orientation of the Brady plan: Mexican loans were selling at a 65 percent discount in the secondary market before Secretary Brady promised official resources to support debt reduction in March of last year.

Suppose also that Mexico's $48 billion long-term public sector debts owed to the banks is converted to ten to fifteen-year bonds with interest rate fixed below the market rate in such a way that the present value of these bonds is $16.8 billion (35 percent of $48 billion). Since the required debt reduction is estimated to ensure that the remaining debts are fully serviceable, a full collaterization will now simply represent inefficient use of resources. The concept of a guarantee fund is more suitable in this case. While the major creditor governments can guarantee the new bonds simply with their mouth, prudence requires setting up a guarantee fund with partial capitalization. For example, one can assume the probability of default is 10 percent and establish a guarantee fund with $1.7 billion. Or, one can be more conservative and have a 20 percent capitalization with $3.5 billion.

The banks absorb a large loss, but unlike in the current accord, they receive a full guarantee on the restructured debts, and they are spared from facing the "voluntary option" of new money. Mexico is clearly much better off -- it is able to devote more resources to its development needs, and it does not need to borrow again from the banks to refinance part of its interest bill. And all this is accomplished with $3.5 billion of official resources -- half of what is now being used to collateralize Mexico's new bonds.

According to the World Bank, nineteen severely indebted middle-income countries (SIMICs) and twenty-seven severely indebted low-income countries (SILICs) owe about $220 billion long-term public-sector debts to the commercial banks. If adequate debt reduction for these forty-six countries calls for an average discount of 50 percent, a fund with a 20 percent capitalization can offer full guarantee to the banks; and $25 billion of official resources can finance this operation. That is much less than $30 to $35 billion available now which almost everyone seems to consider highly inadequate.

The IMF is restricted by its charter from using its resources to directly providing guarantee, and considerations of financial integrity and credit rating constrain the World Bank from taking this burden alone. But if the principle of deep discount in exchange for full guarantee -- supported by a partially capitalized

guarantee fund -- is accepted, there are practical and politically feasible ways of establishing such a fund. For example, one option is modest new appropriations from the major creditor governments disbursed over a five-year period with Japan playing a more significant role. Another option is an innovative use of the newly-established Multilateral Investment Guarantee Agency (MIGA) with financial support coming from gradual sale of a portion of the IMF's gold holdings.

The underlying premises of the second myth have also led to a confused conviction which has greatly complicated the Mexican negotiations, and are likely to do the same in future negotiations.

Confusion 1: Banks must provide new money as debt reduction cannot possibly meet the debtors' financing needs.

With the possibility of deep discount ruled out, the debt managers see little relief coming from debt reduction, and hence follows the official guidance of combining debt reduction with new money. Most bankers reject this exhortation on the part of they are going to write down some of their bad loans to a country with one hand, and then turn around and extend good loans with the other. Many European bankers refuse to provide new loans to the troubled debtors because they are required to set aside additional loan-loss reserves for any new money they provide to the debtor countries.

Once again, the failure to clearly define the concept of adequate debt reduction drives the official debt managers to coax the bankers to pursue bad banking practices. With adequate debt reduction, the debtor country should not need any new money from the banks. More critically, it is highly irresponsible to pressure banks to continue to do what created the debt problems in the first place. The main goal of a new debt strategy should be to revive growth in the debtor countries by cutting their debt service burden substantially, and not to encourage large-scale bank lending to the developing countries for financing their balance of payments deficits.

As steps are taken to resolve the current crisis, efforts should be made to return development finance to the traditional

division of labor. Banks should limit themselves to trade credit, interbank loans and low-risk project finance; the IMF should finance temporary balance-of-payments deficits; and the World Bank and the other regional development banks should provide various types of development (project, and sectoral and structural adjustment) finance.

Finally, the failure to apply the priniciple of adequate debt reduction also creates a confused concern over the use of official resources to support debt reduction:

Confusion 2: The use of official resources to support debt reduction will transfer risk from the private to the public sector.

Former Treasury Secretary James Baker -- architect of the failed Baker plan -- used to attack the notion of official support for debt relief with the argument that it will only transfer private risk to the public sectors. Now some Americans and many Europeans use Secretary Baker's argument to criticize the Brady plan.

Such criticism is both misleading and misguided. To begin with, the debt strategy has been transferring risk to the public sector from day one of the crisis by having the Bretton Woods institutions pull in as the panic stricken private banks have been pulling out with the default risk of the Third World loans rising. The strategy of giving the banks the breathing time and keeping the they are going to write down some of their bad loans to a country offer full guarantee to the banks; and $25 billion of official resources can finance this operation. That is much less than $30 to $35 billion available now which almost everyone seems to consider highly inadequate.

The IMF is restricted by its charter from using its resources to directly providing guarantee, and considerations of financial resources to support adequate debt reduction can actually reduce the risk associated with LDC loans, and thus will upgrade the quality of the loan portfolio of the Bretton Woods twins. Needless to say, if official resources are used to support inadequate debt reduction, then that will not reduce the systemic risk, and instead only perpetuate the process of the risk transfer with the private banks upgrading the quality of their loans. So once again whether the use

of official funds to support debt reduction will reduce the risk of the public sector or transfer additional risk from the private sector will critically depend on whether debt reduction is adequate or not.

Needless to say, to protect their financial integrity, it would be in the self-interest of the Bretton Woods institutions to ensure that the banks provide deep discount to the debtor country. Also, banks should expect full guarantee only if they are willing to provide adequate relief. In fact, the carrot of full guarantee should be used to induce the banks to offer deep discounts. Having contaminated their own portfolio to help the banks to collect interest from the debtors over the last seven years through stepped-up balance of payments loans, the Bretton Woods institutions should by now have all the incentive to upgrade the quality of their loans by making sure that they do not support debt accords where the extent of debt reduction is not adequate enough.

IV. Reforming the Brady Plan

The guidelines for reforming the Brady plan follow from the review of the myths on the Brady plan and lessons from the Mexican accord. The key concept that should lay the foundation for this reform is that of adequate debt reduction. With deep (adequate) discount on the old debts in exchange for full guarantee on the new bonds, the contradiction of combining debt reduction and new money, the frustration over the apparent shortage of official collateral funds and the fear of transfer of risk from the private to the public sector can all be resolved simultaneously.

Four innovations can achieve this goal. First, the Brady plan needs an impartial debt mediator whose mandate will be to devote full attention to help resolve the debt problem. The mediator will also act as an honest broker in negotiations between the debtor and the banks, and if necessary, will engage in "forced mediation" to break logjams. This will be a massive improvement over the current practice of maintaining the fiction of a hands-off approach to the so-called "voluntary negotiations," and yet engage in much-resented arm-twisting on an ad hoc basis. A Debt Restructuring Advisory Committee (DRAC) can be set up for this purpose. Committee members

can be chosen from major creditor governments, the IMF, the World Bank, the regional development banks, and independent nongovernmental experts from the Third World. It can draw on staff resources of the member multilateral institutions.

Second, the committee will agree on an official estimate of adequate debt reduction for the negotiating country. The estimate will form the basis for bargaining.

Third, the banks should not be able to choose between debt reduction and new money. As a group they will first agree on the total amount of debt reduction, and then share it on a pro rata basis. They can choose between principal reduction and interest reduction, but there should be some incentives to encourage them to opt for interest relief. The banks can be induced to accept these negotiating rules by making guarantees for restructuring debt contingent on it.

Finally, the current cumbersome and costly procedure of full collaterization of the principal and partial support for interest payments should be replaced by a partially capitalized guarantee fund. This will greatly simplify the resource allocation process, exempt the debtors from borrowing the collateral, and most importantly, encourage deep debt reductions. The provision of full guarantee is preferable to the option of linking the extent of guarantee to the degree of discount, because partial guarantee will encourage inadequate debt reduction, thus recreating some of the short-comings of the current approach. The offer of full guarantee also requires that the maturity of the new bonds is relatively short but long enough to permit the debtor to return to creditworthiness -- ten to fifteen years. The short maturity will greatly reduce the risk of future default arising from a dramatic adverse change in the government, political upheavals or wars.

These four improvements in the operational and bargaining structure of the Brady initiative can greatly enhance its effectiveness and efficiency. It took nine months to cut by one-tenth the interest burden of Mexico, the model debtor. A strengthened and rejuvenated Brady plan should be able to do much better, much more quickly for the forty-five odd countries that are still waiting to become Brady-eligible.

○